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Draft Guide on access to credit for micro, small and medium-sized enterprises (MSMEs)

Note by the Secretariat

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Background Information

1. At its fifty-second session, in 2019, the Commission agreed to strengthen and complete UNCITRAL work on reducing the legal obstacles faced by micro, small and medium-sized enterprises (MSMEs) throughout their life cycle with guidance on access to credit for MSMEs and requested the secretariat to start preparing draft materials with a view to their consideration by Working Group I.

2. At its thirty-sixth session (Vienna, 4 to 8 October 2021), the Working Group commenced its deliberations on the topic on the basis of a preliminary draft text contained in a Note by the Secretariat ([A/CN.9/WG.I/WP.124](#)). The Working Group continued such work at its thirty-seventh session (New York, 9 to 13 May 2022), thirty-eighth session (Vienna, 19 to 23 September 2022), and thirty-ninth session (New York, 13 to 17 February 2023) on the basis of revised Notes by the Secretariat ([A/CN.9/WG.I/WP.126](#), [A/CN.9/WG.I/WP.128](#) and [A/CN.9/WG.I/WP.130](#), respectively). In its deliberations, the Working Group agreed that the draft text would take the form of a guide and its final title would be *Guide on access to credit for micro, small and medium-sized enterprises (MSMEs)*.

3. At its thirty-ninth session, the Working Group decided to transmit the draft guide, to the Commission for consideration and adoption (A/CN.9/1128, para. 70). The text is reproduced as an annex to this Background Information.

1. The current revision of the draft guide on access to credit for MSMEs

4. The draft guide before the Commission not only reflects the decisions of the Working Group at its thirty-ninth session, but also incorporates editorial adjustments made by the secretariat in order to facilitate the cohesion and consistency of the text. The Commission may also wish to note that in a few instances the secretariat has revised the commentary to better align it with revised or new recommendations (for example, the discussion on the key features for an effective legal framework for using immovable assets as collateral in chapter III, B.2). In order to be consistent with the final form in which the draft guide will be published, guidance to the changes arising from the deliberations of the Working Group is not reflected in footnotes to the text and the Commission might wish to refer to the report of that meeting.

2. The final version of the Guide on access to credit for Micro, Small and Medium-sized Enterprises (MSMEs)

5. Once adopted, the Guide will be published in electronic and paper format as part of the UNCITRAL “MSME texts series”. A short “Preface” reading along the following lines will introduce it:

“The Guide on Access to Credit for Micro, Small and Medium-sized Enterprises (MSMEs) was prepared by the United Nations Commission on International Trade Law (UNCITRAL) and adopted at its fifty-sixth session in 2023 (Vienna, 3–21 July). The project arose from a decision of the Commission at its fifty-second session, in 2019, to strengthen and complete the work of UNCITRAL on reducing the legal obstacles faced by MSMEs throughout their life cycle. For this reason, the Commission requested the secretariat to prepare materials on MSMEs’ access to credit, drawing as appropriate on the UNCITRAL Model Law on Secured Transactions, for the consideration of Working Group I (Micro, small and medium-sized enterprises or MSMEs).¹

The Working Group considered the first draft of the materials prepared by the secretariat at its thirty-sixth session (Vienna, 4–8 October 2021) and continued its deliberations on the text until its thirty-ninth session (New York, 13–17 February 2023). The Working Group agreed that the materials should take the final form of a Guide. The Working Group also agreed that the Guide

¹ Official Records of the General Assembly, Seventy-fourth Session, Supplement No. 17 (A/74/17), para. 192 (a).

should mainly focus on micro and small enterprises as they often face more challenges to obtain credit than medium-sized enterprises. In this respect the Guide differentiates, as appropriate, the provisions and measures respectively applicable to micro and small enterprises and to medium-sized ones.

In addition to representatives of the member States of the Commission, representatives of observer States and a number of international organizations, both intergovernmental and non-governmental, participated actively in the preparatory work.

The final negotiations on the draft text were held during the fifty-sixth session of the Commission and the text was adopted by consensus on [____]. Subsequently, the General Assembly expressed its appreciation to UNCITRAL for completing and adopting the Guide in resolution [insert the number of the resolution].”

6. The Guide in its final version will also contain as annexes: (i) a list of all recommendations; (ii) the Commission’s decision to adopt the guide; and (iii) an index.

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Annex

I. Introduction

1. Micro, small and medium-sized enterprises (MSMEs) account for the major share of businesses in most parts of the world. They contribute to, supply chain development, innovation and economic and social welfare. They offer employment and entrepreneurship opportunities for many including young people, women and groups that may be disadvantaged on the job market such as migrants, ethnic minorities and persons with disabilities. MSMEs thereby also contribute to inclusiveness and poverty reduction.

2. There is no global standard definition of MSMEs. Different countries and regions use different criteria according to the economic, legal, political and social context. While number of employees, annual sales turnover, and value of assets are the criteria more commonly used, other variables, such as compliance with registration and other formalities, years of experience or initial investment amount are also used. Mindful of these differences, the UNCITRAL legislative texts on MSMEs do not include a definition of MSMEs. States may apply the texts, including this Guide, in the light of their own definitions.

3. Despite their varying nature, size and country of operation, most MSMEs broadly share the following characteristics (although some mainly apply to micro and small enterprises, while others are relevant for all types of MSMEs): (a) small size and often family-run; (b) few or no employees and difficulty in hiring and retaining staff; (c) reliance on kinship networks for finance or risk-sharing; (d) limited access to finance (e) difficult access to financial services; (f) disproportionate impact of regulations (e.g. business registration procedures and cost); (g) limited markets (for micro and small enterprises, often only local markets); (h) limited access to formal dispute settlement mechanisms; (i) difficulty in partitioning business assets (particularly in the case of sole proprietorship or when the business does not have a distinct legal personality) so business failure often directly impacts personal and difficulty in transferring or selling the business; (j) vulnerability to financial distress or natural disasters; and (k) difficulty in transferring or selling the business.

4. Access to finance in the form of credit, savings, payment facilities, and insurance, is essential for MSMEs throughout their life cycle. It enables entrepreneurs to start, innovate, improve efficiency and productivity, generate income, and eventually expand their businesses. Lack of or limited access to finance is one of the obstacles small businesses face in emerging markets most cited by them. Access to credit, which is the focus of this Guide, refers to the ability of MSMEs to obtain financing for their formation and operation. Various factors may affect access to credit and the types of available credit, including age of the enterprise, gender of the entrepreneur, account history of personal and business bank accounts owned by the entrepreneur, and availability of business records. This introduction reviews some of the reasons that may make access to credit challenging for MSMEs and canvasses initiatives that may address such challenges.

A. MSME finance gap

5. MSMEs may seek access to credit through financial institutions operating within the domestic legal and regulatory framework. However, MSMEs, in particular micro and small enterprises, often fail to meet the conditions imposed by financial institutions for granting loans. Even when they meet those conditions, financial institutions might still be reluctant to grant loans to micro and small enterprises because those loans are often too small to be profitable. The difference between the current supply of finance to small businesses and their potential demand is known as “the finance gap.”

6. Studies¹ have shown that in many countries the finance gap is likely to be greater for business owned by women than for men-owned ones because of cultural biases or economic, social and legal constraints. For instance, in some countries women are reported to have less access to affordable credit since they have insufficient credit history or no or fewer assets to offer as collateral. Women-owned micro and small enterprises might also face higher funding cost than those owned by men. For example, many women-owned small businesses operate in relatively marginal market sectors or suffer the effects of gender-biased credit scores² that lead to higher interest rates of business loans. As a result, women entrepreneurs are more likely to be dependent on informal sources of credit, including friends, family and peers' networks.

7. Measures aimed at reducing the MSME financing gap should aim at striking a balance between minimizing the credit risk faced by financiers and the need to protect MSMEs, especially the most unexperienced and unskilled ones. Such measures will also make an impact on achieving the sustainable development goals (SDGs). Indeed, given their central role in the developing countries' economy and the large share of female entrepreneurs, measures to support MSME access to credit would positively support countries' efforts to achieve SDGs 1 and 5.³ Moreover, the International Trade Centre (ITC) suggests that stronger MSMEs can contribute to achieving SDGs 8 and 9 through the business practices they adopt, the sectors in which they operate and their impact on the broader economy.⁴ It further emphasizes that MSMEs can have a positive impact on 60 per cent of the individual SDG targets with sufficient funding in place. Improved access to credit for MSMEs would enhance their potential to grow and scale up.

B. Reform trends

8. Efforts at the global, regional and national levels to facilitate MSMEs' financing have generated several best practices capable of benefitting countries at various stages of economic and social development. Some initiatives have focused on promoting MSMEs' access to financial services, for example, saving accounts, payments transfers, new insurance products. Others have focused on measures tailored to facilitate access to credit. Many of those efforts have prioritized policies and regulations promoting financial assistance to MSMEs (often defined as hard support policies), such as establishing credit guarantee schemes, or direct lending programmes to MSMEs (e.g. allocating a percentage of the bank's loan portfolio to the MSME segment or facilitating the adoption of measures to improve competition within the domestic financial systems (allowing a variety of financial institutions to operate in the credit market in addition to banks or other regulated financial providers is expected to increase lending options for MSMEs). Other interventions have favoured the adoption of soft support measures including capacity-building programmes for MSMEs, financiers and regulators and strengthening of credit reporting systems. Recognizing that women-owned MSMEs often face higher barriers than MSMEs owned by men in accessing credit, States and international organizations alike have implemented specific policy initiatives to support this category of MSMEs.

¹ World Bank Group, SME Forum and International Finance Corporation, MSME Finance Gap, Assessment of the shortfalls and opportunities in financing micro, small and medium enterprises in emerging markets, 2017.

² Credit score is an indicator of a borrower's (individual or small business) creditworthiness. It is usually expressed as a three-digit number and is based on the borrower's credit history.

³ SDG 1 calls for the end of poverty in all its forms everywhere. SDG 5 aims to achieve gender equality and empower all women and girls.

⁴ ITC, SME Competitiveness Outlook 2019: Big Money for Small Business – Financing the Sustainable Development Goals, 2019, SDG 8 relates to the promotion of sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all. SDG 9 relates to building resilient infrastructure, promoting inclusive and sustainable industrialization and fostering innovation.

9. Many global and country level efforts in recent years have also drawn particular attention to the role that digital financial services and products resulting from the use of modern technology can play in facilitating access to credit for MSMEs. For example, in certain countries regulatory authorities have developed projects to test and further research on the use of technology such as blockchain and smart contracts in order to improve access to credit for unfunded or underfunded MSMEs. As recognized⁵ by the Group of 20 (G20),⁶ the digitalization of financial services is a potential game changer for small business financing since it potentially can make financial processes, including lending, significantly cheaper, faster and easier. In this regard, the United Nations Secretary General's Task Force on Digital Financing for the Sustainable Development Goals has recommended, among others, legal reforms to support the digitalization of the financial system, for example defining the legal nature of digital assets or improving private law regimes governing relations between commercial parties.⁷

10. Finally, several initiatives, in particular at the global and regional levels, have encouraged the adoption of modern laws in areas that are instrumental to facilitate access to credit for MSMEs, such as secured transactions and insolvency law. Other reforms have pursued formalization of small businesses through streamlining business registration and simplified organizational forms for MSMEs (see paras. 61 to 70), which facilitate MSME formation and operation and their access to formal credit sources.

C. Focus and structure of the Guide

11. Drawing on the best practices described in the previous paragraphs and on international standards (including UNCITRAL texts on secured transactions), the Guide aims to assist States wishing to introduce legal reforms to facilitate MSMEs' access to credit. International intergovernmental organizations, non-governmental organizations (NGOs), professional or industry associations and other stakeholders that are interested or actively involved in technical assistance to support MSMEs' formation and operation may also benefit from this text.

12. The Guide recognizes that although several features are common to many MSMEs regardless of their size and nature, it is often more challenging for micro and small enterprises to obtain credit than for medium-sized enterprises, as certain obstacles (for example high interest rates, or provision of collateral) may affect smaller MSMEs more severely. The Guide thus differentiates, as appropriate, the provisions and policy measures respectively applicable to micro and small enterprises and to medium-sized ones. Consistent with the principle "think small first," the Guide mainly focuses on micro and small enterprises, but retains the acronym MSME for ease of reading.

13. The Guide discusses the legal framework relevant to access to credit and its improvement. Since policy and support measures also play an important role in creating an enabling environment for access to credit, the Guide also refers to those measures to the extent they can enhance the effectiveness of the legal framework in reducing constraints on MSMEs' access to credit. The Guide, however, does not discuss measures such as direct State support to MSMEs or taxation policies, which are common in many countries, and leaves them to States to decide.

⁵ World Bank Group, Promoting digital and innovative SME financing, 2020, page 9. The report was produced by the World Bank Group for the G20 Global Partnership for Financial Inclusion under the Kingdom of Saudi Arabia's G20 Presidency.

⁶ The Group of 20, usually known as the G20, is an intergovernmental forum comprising the world's major economies. It started in 1999 as a meeting for the finance minister and central bank governors and has evolved into a yearly summit involving the Heads of State and Government.

⁷ United Nations Secretary General's Task Force on Digital Financing for the Sustainable Development Goals, *People's Money: Harnessing Digitalization to Finance a Sustainable Future*, 2020.

14. In addition to the present introduction, the Guide contains two chapters. Chapter II sets out the most common sources of credit and capital available to MSMEs throughout their life cycle and the challenges MSMEs may face in accessing them. Chapter III examines the legal, policy and regulatory measures that facilitate MSMEs' access to credit and includes recommendations to advise States on how to devise a legal framework promoting access to credit for small businesses. The chapter concludes with a discussion, supported by a recommendation, of strategies and tools to build MSMEs' financial literacy and improve financiers' and regulators' capacity to serve them.

II. Sources of credit and capital available to MSMEs

15. Sources of credit and capital for MSMEs comprise the various debt tools mentioned in this chapter as well as equity investment, including investment modalities tailored to MSME and start-ups, such as business angel investments⁸ and venture capital.⁹ While some sources may be relevant at all stages of MSMEs' life cycle, others are more attractive to MSMEs at a particular stage of development. Importantly, facilitating MSME access to these legitimate credit sources reduces the likelihood of borrowing from illegal credit markets. Considering that the notion of "credit" is generally associated with debt, this chapter focuses on relevant debt tools and challenges faced by MSMEs when accessing such debt tools, and only touches upon equity in the context of family and friends support given its significant relevance for MSMEs and, shortly, in that of Islamic finance.

16. Digital technology developments in the last decade have resulted in financial services and products as well as business models that may facilitate MSMEs' access to credit in a faster, more convenient, and sometimes cheaper way than the traditional methods (although in some regions the relatively high cost of internet may make it less competitive). Partly due to the low cost of mobile phones and their data networks in some regions, the use of mobile phones has expanded to more advanced transactions concluded via mobile applications, such as digital credit that is often instant, automated and remote. For the many women who combine household chores with work outside the home, digital financial services may improve access to credit by easing time constraints. This is even more the case where geographical distance to markets and financial services is significant.

A. Friends and family support

17. In addition to their own financial resources (e.g. savings), MSMEs' owners often rely on friends, family and peer networks as sources of capital at the initial stages of the business and beyond (this is commonly known as "friends and family" support). Given their personal relationship with the owner, friends and family are often more willing to provide financing to the business, whether through gift, debt or equity, especially when other financial sources (e.g. commercial credit) are not accessible or not affordable. Alternatively, friends and family may personally guarantee the financial obligations of the MSMEs with their properties or assets, often upon request of the financier.

18. From the perspective of MSMEs, financial support from friends and family offers advantages in comparison with commercial sources of funding, in particular short to medium-term borrowing. Friends and family are often less concerned by the MSME lack of credit history and may not require collateral or detailed business plans or other documentation (in the case of equity). In addition, the loan or investment

⁸ Business angel investments are investment made by wealthy individual(s) who provide financing, typically their own funds, in exchange for ownership equity.

⁹ Venture capital refers to private equity investments by venture capital firms or funds in unlisted enterprises, with the aim of bringing capital, technical and managerial expertise to increase the enterprise's value and make a profit on its sale or public listing.

terms may be more flexible and cover a longer period as compared to commercial credit, which facilitates repayment by MSMEs. As noted earlier (see para. 6), support from friends and family plays an important role for women entrepreneurs as well as other groups likely to be more economically and financially vulnerable (e.g. ethnic minorities). Indeed, these groups may face higher barriers to access formal credit. In addition to low creditworthiness due for example to lack of credit history, as stated above (para. 6), in some countries social norms or discriminatory biases may restrict the capacity of members of those groups to have property rights and access credit.

19. Support from friends and family often comes on an informal basis which may facilitate agreement on its terms and conditions and adapting them to the changing circumstances of the MSME. However, when loans are agreed orally and not recorded in writing, uncertainty and doubts as to their terms and conditions, repayment schedules and remedies for defaults are bound to arise over time. In certain cases, oral agreements may make it difficult for an MSME to understand whether the financial support comes as a loan or a gift and in certain countries either of these two forms might have tax implications for the MSME recipient or the donor or both. Informal agreements are also an inadequate vehicle for the provision of equity capital, as they do not offer a reliable record of the parties' agreement on decision-making rights in the business, on how the terms of the investment may affect the MSME governance, the liability of its members and whether and how the investors can modify or sell their interests in the business. Even when the parties are aware of their mutual rights and obligations, personal ties, local customs and culture may still lead entrepreneurs and friends and family to forego an accurate assessment about the risks they are assuming or neglect to formalize their agreements in a manner that provides adequate record for future reference.

B. Commercial credit

20. Commercial credit in this context refers to secured and unsecured credit provided by banks or other regulated financial institutions (including investment funds) primarily based on the overall creditworthiness of enterprises, with their expected future cash flow being usually considered as the main source of repayment. Most often, commercial credit is secured by assets of the borrower that the financier can seize if the borrower defaults (as opposed to unsecured credit in which the lender's recourses are limited to obtaining a personal judgment against the borrower for the amount due). As discussed in detail in chapter III of the Guide, secured loans are particularly important to facilitate access to credit for MSMEs since they reduce the financier's risk in lending and thereby often allow for more favourable loan conditions. Domestic laws governing contracts, secured transactions and dispute resolution, as well as the domestic regulatory framework concerning the operation of banks and other financial institutions need to be taken into account when extending commercial credit.

21. Specific challenges that limit this form of credit to MSMEs in many countries largely relate to the difficulties that financiers encounter in assessing and monitoring the creditworthiness of MSMEs and their lack of adequate collateral to secure the loan. Banks and other financial institutions are usually reluctant to extend uncollateralized credit to micro and small enterprises even at high interest rates. Collateral requirements are relatively high worldwide and many micro and small enterprises do not have assets with the necessary value or of the adequate type to serve as collateral. Household goods owned by micro and small enterprises are often not accepted as effective collateral given that they generally have low value, depreciate too quickly, and may even be exempted from judicial enforcement processes. Microlenders sometimes may accept jewellery and even household furniture and appliances as collateral. From the perspective of microlenders, these forms of collateral serve primarily to demonstrate the microenterprise's commitment, rather than as a secondary repayment source.

22. Financers are also likely to incur high due diligence costs relative to the size of the loan usually resulting in high interest rates and high service fees, which may also discourage MSMEs from applying for commercial credit. It has been observed¹⁰ that in some countries, a less competitive banking sector may also contribute to the high cost of credit. Because of lack of competition, banks and other similar financial institutions often have fewer incentives to service MSMEs and develop adequate products for that market segment. In this respect, the absence of State's support measures to incentivize bank lending to MSMEs (e.g. increases in the coverage of public credit guarantee schemes or strengthening banks' lending capacities with more direct measures such as flexibility in loss accounting) may also affect banks' propensity to support MSMEs.

23. As discussed earlier, women entrepreneurs may face more difficulties in accessing commercial credit due to legal, institutional and sociocultural factors. In some countries, restrictions on opening or using a bank account, such as the requirement for a male family member's permission or authorization, limit women's access to bank accounts. Moreover, partly due to lack of, or limited access to, financial or formal education, women in certain countries cannot access other formal financial services, such as savings, digital payment methods or insurance. It has been reported¹¹ that in some countries due to a lack of formal financial transaction records, there is frequently no credit information about women entrepreneurs for the purpose of risk assessment, which further restricts their ability to obtain commercial credit. In other countries, women do not have the right to administer marital property, including property that they brought into the marriage and property acquired during the marriage which considerably limits their ability to offer collateral in order to access credit.

C. Credit cards

24. Credit cards are generally available in many jurisdictions for MSMEs with access to bank accounts. While in some jurisdictions MSME entrepreneurs tend to use personal credit cards for business purposes, in other jurisdictions business credit cards are more widely used. Business credit cards can be issued by commercial or development banks. The credit limit on a business credit card is often higher than a personal credit card. Certain credit cards issued by development banks may offer relatively low charges and low interest rates for MSMEs and in some cases are subsidized by the government. In general, it can be easier for small business owners to qualify for a credit card rather than a bank loan due to the former's less strict qualification criteria.

25. The issuance of credit cards is usually subject to existing laws and regulations on contracts and dispute resolution, as well as existing regulatory systems concerning the operation of banks (including specific rules for services provided by development banks). Although credit cards issued by development banks to MSMEs are generally tailored to accommodate the financing needs of small business owners, those issued by commercial banks may impose high interest rates and high default charges. Moreover, many small business credit cards may require business owners to personally guarantee for any late or missed payments by the enterprise. Small business credit cards also often provide less protection than consumer credit cards (e.g. no guaranteed service when disputing billing errors). In some cases, lack of recourse mechanisms for credit card holders to file a complaint raises additional concerns.

¹⁰ Inter-agency Task Force on Financing for Development, Financing for Sustainable Development Report 2020, p. 64.

¹¹ World Bank, SME Forum and International Finance Corporation, MSME Finance Gap, Assessment of the shortfalls and opportunities in financing micro, small and medium enterprises in emerging markets, 2017.

D. Platform-based crowdfunding

26. Crowdfunding is a technique to raise external finance from a large audience (the “crowd”), rather than a small group of specialized investors, where each individual provides a small amount of the funding requested. In platform-based crowdfunding, a web platform, often operated by a FinTech company,¹² functions as an intermediary connecting MSMEs in need of capital or credit with potential financiers (investors or lenders). The two most common types of crowdfunding are lending crowdfunding (also known as peer-to-peer lending) and investment-based crowdfunding. The two models are quite similar and sometimes certain aspects may overlap. The main difference is that lending crowdfunding is loan-based, while investment-based crowdfunding aims at raising credit by issuing securities.

1. Lending crowdfunding (peer-to-peer lending)

27. Lending crowdfunding is usually described as the provision of credit through online platforms that match borrowers with lenders. Loans obtained through the platforms are usually unsecured. Some platforms enable lenders to make a direct loan to an individual or an enterprise while other platforms enable lenders to invest in pools or portfolios of loans indirectly. Lenders may bid for loans by offering an interest rate at which they will lend. Borrowers then accept loan offers at the lowest interest rate. Competition with respect to interest rates is one of the benefits for MSMEs. Another is the possibility for MSMEs to obtain very small loans that financial institutions might refuse to provide.

28. The platform can provide services to assist matching lenders with borrowers and to facilitate the provision of the loan. For example it can assess information on the loan applicant, provide the standard terms and other elements for the loan contract and methods or parameters for loan price setting. It can also service the loan by disbursing loan funds to borrowers, collecting repayments by borrowers for lenders and dealing with loan defaults.

29. The characteristics of lending crowdfunding platforms may vary significantly internationally and within domestic markets. Generally, existing commercial laws and regulations governing electronic contracts and dispute resolution also apply to lending crowdfunding, along with any specific regulatory measures. The growth of lending crowdfunding platforms in recent years has increased the need to ensure protection of the platforms’ users, both financiers and MSME borrowers, as several countries have experienced platform failures resulting in major financial losses for the users. Many of the risks relating to lending crowdfunding platforms are not different in nature from those in traditional lending, but they are amplified by the medium and the modality through which credit is provided. Many of those risks are also similar to those of investment-based crowdfunding: they can range from technology related risks (e.g. instability of the platform) to management related risks (e.g. misconduct, negligence, insolvency, or even fraud, of the platform operators), and to deficiencies of the business model (e.g. lack of adequate information on the terms and conditions to access the platform, inadequate credit assessment and conflict of interests between the platform operators and the lenders or borrowers).

2. Investment-based crowdfunding

30. Investment-based crowdfunding is typically offered through an online platform which connects investors with MSMEs wishing to raise funds by issuing securities, including debt securities. The platform usually allows applications to be completed

¹² FinTech are mainly companies from the technology sector that specialize in the delivery of a particular financial product or service through the use of innovative technologies and business model. For example, they can operate as digital payment providers, digital insurers, digital-only banks, or peer-to-peer lending platforms. In some countries they do not require a banking license to operate; while in others, legislation places them under the supervision of the domestic financial market authorities.

within a few hours, and this is one of the reasons crowdfunding has gained popularity among MSMEs in many countries.

31. Given its design and due to regulatory limitations, investment-based crowdfunding is suitable for MSMEs (in particular micro and small enterprises) at their initial stages as they require relatively small amounts of funding. It may be less suitable for MSMEs in very high-tech and cutting-edge areas requiring specific knowledge on the side of investors. Furthermore, crowdfunding may have limited use for MSMEs with larger equity capital needs as institutional investors are unlikely to use online platforms and may still prefer in-person meetings to obtain the extensive information exchange necessary for them to feel comfortable in providing large loans.

32. Existing laws and regulations governing electronic contracts and dispute resolution usually apply to investment-based crowdfunding. Although crowdfunding is often exempted from the application of traditional capital markets rules (e.g. publishing a prospectus, obtaining necessary authorizations, complying with reporting and corporate-governance requirements), many countries have introduced or are in the process of introducing specific crowdfunding rules to regulate the activities of issuers, platform operators and investors.

33. MSME issuers and investors face several obstacles to crowdfunding. Firstly, investors may not have sufficient information or be misinformed about the operation of the platforms, or the risk profiles of projects intermediated through such platforms. Secondly, data security concerns and the use of crowdfunding for illicit activities may pose legal risks. Thirdly, the absence in some jurisdictions of a specific legal and regulatory framework for investment crowdfunding specifying the legal nature and the default legal regime does not help improve the business environment. As noted above (paragraph 32), some jurisdictions have put in place legal and regulatory measures to protect investors (e.g. investment caps, and reflection periods during which investors may revoke offers, disclosure, due diligence, conflict of interest, insurance and reporting requirements for platform operators, as and complaints handling procedures). The need for some degree of regulatory intervention is illustrated by the fact that investment-based crowdfunding in several domestic markets ceased operations or shrank significantly due to concerns about dubious or outright fraudulent behaviour and insufficient capital requirements and loss provisions for investors. At the same time, however, while the insufficient crowdfunding regulation can leave investors and MSME issuers unprotected, excessive regulation can make implementation of investment-based inefficient.

E. Leasing

34. Leasing is an asset-based financing tool that allows businesses in many countries to finance the use and possible ultimate purchase of equipment or other assets. Under an “operating lease” agreement, the owner (i.e. lessor) of the leased asset gives the business (i.e. the lessee) the right to use it for an agreed period in return for regular (usually monthly) lease payments. In most countries, operating leases are effective against third parties without any requirement for public registration. While the *UNCITRAL Model Law on Secured Transactions* (2016)¹³ does not apply to operating leases, some domestic secured transactions laws may incentivize lessors to register their interests in a security rights registry or another registry where operating leases may be recorded in the country so to alert third persons that the lessee does not own the leased assets in its possessions and control.

35. In a “financial lease” (or “finance lease”), the lessee benefits from the economic life of the asset similarly to a legal owner and takes on corresponding obligations such as maintenance and insurance. Typically, the lessee has the option to purchase the asset for a nominal price at the end of the lease term. Under some forms of financial

¹³ The *Model Law* is available in all six official languages of the United Nations at <https://uncitral.un.org/> – section “Texts and Status – Security Interests.”

lease, the title to the asset is transferred to the lessee automatically at the end of the lease term. Under the *UNCITRAL Model Law on Secured Transactions*, a lessor may have an acquisition security right (see article 2(b)), which could benefit from a special priority subject to meeting the applicable requirements, especially the timely registration. Accordingly, the lessee is considered to be the owner of the leased object and the lessor to have an acquisition security right. This allocation of property rights applies under the secured transactions law, while for accounting, tax and other purposes the lessor may be treated as the owner.

36. Financial lease is a form of short to medium-term financing that businesses use to acquire durable assets, instead of borrowing to purchase them. It allows MSMEs to preserve cash resources as it requires no or only a small down payment. This feature makes it a valuable option for start-ups that lack the necessary funds to buy equipment or MSMEs that do not qualify for commercial credit (see para. 21). A financial lease can also be helpful for MSMEs in financial difficulties, in particular when the leased asset (e.g. equipment) generates cash flow. Leasing, however, can be more expensive than an outright purchase due to the higher cost of paying for the leased asset over its economic life. Furthermore, MSMEs' failure to honour their lease payment usually results in repossession of the leased asset by the lessor, which could compromise the MSME's business operations.

37. Leasing may become a costly financing option for MSMEs if the legal basis for the lessor's right to repossession on default is inadequate, or if there is no public registration requirement to reduce the risk of an unauthorized sale of the leased assets by the lessee. Similarly, inadequate norms on the formation, licensing and operation of leasing companies may result in unnecessarily high leasing costs. Leasing companies are usually non-deposit taking institutions and they are subject to less stringent capital requirements than banks. While this may afford them more flexibility, it may also constrain them to source funds from more volatile markets that may affect the terms and conditions under which they can lease equipment or other assets to MSMEs. One of the major constraints on the ability of regulated financial institutions to provide MSME financing in the form of leasing may be limitations resulting from local prudential regulations regarding minimum regulatory capital. This may make leasing unprofitable for such institutions, thus limiting MSMEs' options to access this form of financing.

F. Receivable Financing

38. Receivable financing refers to any financing arrangement that uses an amount payable by one party to another for goods or services as the basis for advancing funds to the party to whom the payment is owed. Financing can take the form of an outright sale of the receivable at a discount or the receivable being used as collateral to secure a loan.

39. Factoring is a type of receivable financing and is traditionally used to finance the activities of MSMEs.¹⁴ In order to decide whether to purchase receivables, besides the enforceability of its rights to payment the factor primarily focuses on the creditworthiness of the enterprise's customers who owe payment of the receivable to it, as evidenced by the invoices, rather than on the enterprise's financial statements, fixed collateralizable assets or credit history. MSMEs with a creditworthy pool of customers can often obtain financing from a factor at better terms than they might obtain from a bank on the basis of their own credit record. In jurisdictions where government agencies are reported to delay payments to public contractors and suppliers, factors with the knowledge and experience to collect payment from

¹⁴ There are a number of different types of factoring arrangement. The factor (assignee) may pay a portion of the purchase price for the receivables at the time of the purchase (discount factoring), it may pay only when the receivables are collected (collection factoring), or it may pay on the average maturity date of all of the receivables (maturity factoring). *UNCITRAL Legislative Guide on Secured Transactions*, 2007, Introduction, para. 32.

government agencies may also help MSMEs face cash flow problems when providing goods or services under a government contract, a business model known as “government invoice factoring.”

40. Receivables finance can also provide funds for MSMEs within supply chains. Supply chain finance uses various financing and risk mitigation practices and techniques to optimize the management of working capital. Buyers and sellers with an existing business relationship in a given supply chain are likely to fund supply chain processes and transactions on an “open account” basis. The supply chain finance “add-on” is the interposition of a bank or FinTech company as a financing intermediary. Supply chain finance solutions encompass a combination of technology and services that link buyers, sellers and banks or FinTech companies to facilitate financing during the life cycle of the open account trade transaction and repayment. Supply chain finance provides MSME suppliers with a range of options for accessing affordable financing (such as receivables discounting, forfaiting, distributor finance and pre-shipment finance),¹⁵ thereby reducing the time taken to collect payment and thus significantly improving MSME suppliers’ cash flow. Notably, reverse factoring is also a key component in supply chain finance as a means for creditworthy buyers to approach their own financial institutions to facilitate favourable financing options for their MSME suppliers.

G. Warehouse receipt financing

41. Warehouse receipt financing is a mechanism that uses a receipt representing goods received by a bailee for storage as collateral to secure loans. Warehouse receipt financing is appropriate for all types of goods, but it is particularly suitable for agriculture products. It can especially benefit small farmers as it enables the farmers to sell the goods on the market when the prices are higher. Warehouse receipt financing effectively manages price seasonality and positively affects financial and planting decisions. Warehouse receipt financing is also advantageous for financiers since it helps reduce their lending risks with marketable collateral. In certain countries, financiers participate in the management of the warehouse jointly with the farmers’ organization, which improves mutual trust between them and the farmers and might help them to better monitor the collateral.

42. However, this financing tool requires modern legislation which (i) recognizes warehouse receipts as documents of title; (ii) clearly identifies the rights and obligations of all parties; (iii) establishes procedures for transferring the receipts; (iv) specifies the rights of the transferees; and (v) provides for simple and speedy enforcement processes. In addition to an adequate private law framework and effective regulation, including the licensing of warehouses and the systems to guarantee their performance, countries should have in place adequate infrastructure and secondary markets for warehouse receipts or commodities. Studies have shown that in countries where those elements are absent, high transaction costs and interest rates do not make warehouse receipt financing suitable for accessing credit.

H. Letters of credit

43. Letters of credit incorporate an irrevocable undertaking by a bank on behalf of an applicant (typically a buyer under a sales contract) to pay a specified sum to the beneficiary (typically the seller) upon presentation of documents found by the bank

¹⁵ Receivables discounting refers to the financing technique under which companies discount all or part of their receivables (represented by outstanding invoices) to a financier to provide a one-off cash injection for a particular purpose; forfaiting refers to the purchase of a future payment obligation without recourse; distributor finance is generally made available to the distributor of a large manufacturer to cover the holding of goods for resale and to bridge the liquidity gap until they receive funds following the sale of goods; and pre-shipment finance, also known as purchase order finance, is commonly provided against purchase orders on a transactional basis but can also be made against demand forecasts or underlying commercial contracts.

to comply with the terms and conditions stated in the letter of credit. Most commercial letters of credit contain clauses that incorporate by reference the *Uniform Customs and Practice for Documentary Credits* (UCP), promulgated by the International Chamber of Commerce (ICC) which thus become part of the letters of credit agreement. Banks may also issue standby letters of credit to guarantee the performance of other contractual obligations. Unlike letters of credit, however, standby letters of credit are only called when the main obligation is not performed (see para. 100). As in the case of the UCP, the *Uniform Rules for Demand Guarantees*, also prepared by the ICC, may be incorporated by reference in standby letters of credit, thus making them part of the credit agreement.

44. Letters of credit are mainly used by businesses engaging in cross-border sales, which in the MSME group are often medium-sized enterprises. They can be an attractive tool for MSMEs that sell goods cross-border, since it is only the creditworthiness of the bank that issued the letter of credit on behalf of the buyer, and not that of the buyer, that is relevant to the seller's risk assessment. However, the MSME seller (beneficiary of the letter of the credit) must be able to provide precisely defined trade documentation in strict compliance with the terms of the letter of credit, the bank being under an obligation to honour the letter of credit if the presentation is complying. Letters of credit can also be an attractive tool for MSMEs who buy goods cross-border. However, MSME buyers may not have sufficient resources or collateral to cover the cost of the letter of credit and the issuing bank's fee. For all these reasons, letters of credit may not be a viable option for MSMEs that engage in small-value cross-border transactions whether as buyers or sellers.

I. Collective credit and savings arrangements

45. Credit cooperatives (also known as credit unions) are a popular type of collective savings arrangement for MSMEs and individual entrepreneurs. They are formally regulated non-profit organizations jointly owned and controlled by their members. Their purpose is to meet the financial (including credit and savings) needs of their members while often also serving their common economic, social and cultural aspirations. As such, credit cooperatives are legally recognised and registered associations with their own statutes and banking license where required, and their operation is often subject to specific laws and regulations. Their members deposit their savings in a common pool with the aim of creating a fund to satisfy their credit and other financial needs. Membership in cooperative banks may be restricted to employees of a particular company, residents of a defined neighbourhood, members of a certain labour union or religious organizations, and their immediate families.

46. Other collective savings and credit arrangements consist of rotating savings and credit associations (ROSCA), and accumulating savings and credit associations (ASCA). While generally not formally recognised or regulated by State law, ROSCAs and ASCAs are a popular source of financing for micro and small enterprises, individual entrepreneurs and traders, particularly women. Under the ROSCA arrangement, individuals form a group and select a treasurer who periodically (e.g. daily, weekly) collects a given amount from each member. The money collected is then transferred in rotation to each member of the group. In comparison, members of an ASCA save money through regular deposits with a treasurer. The money deposited can also be lent to members under certain terms and for a fee. Given the way they function, the amount of the credit supplied through ROSCAs and ASCAs is generally limited to the amount that their members can collect jointly. Moreover, access to credit by ROSCAs and ASCAs can be limited when the funds collected cannot be moved over large distances as may be the case in rural areas where local markets may be segmented from national markets and there is no access to appropriate money transfer services. In a number of jurisdictions, ROSCAs and ASCAs are commonly referred to as *tontines*. In addition to taking the form of a ROSCA or an ASCA *tontines* may also be a hybrid of both types. In some countries, there also exist a form of individual *tontines* (known as "mobile bankers") where monetary contribution is

made by one person to a *tontine* who typically visits the person to collect contribution, thus saving their time to deposit their savings elsewhere.

47. Loans extended by such collective credit and savings arrangements are also subject to the existing rules of commercial law concerning contract formation and dispute resolution. In some jurisdictions, their operation is also subject to specific laws and regulations. Such arrangements are generally used by micro and small enterprises to obtain credit and often do not allow savings to be collected from more than a small group of individuals well known to one another. The functioning of such arrangements is built upon trust among members, and the funds collected cannot be moved over large distances which limits the supply of credit, especially in rural areas where local markets may be segmented from national markets. Moreover, there is a risk of potential breakdown of certain arrangements if a member defaulted.

J. Microcredit

48. Microcredit is a common form of microfinance that involves a small loan often granted to an individual or microenterprise to start and operate a business. The structure of microcredit agreements often differs from traditional banking. They are also usually less formalistic and might not even be recorded written agreement. In some instances, the microcredit is guaranteed by an agreement with the members of the borrower's community, who would be expected to compel the borrower to work towards repaying the debt. The borrower may become eligible for loans of larger amounts after it successfully pays off the microcredit. Given that many borrowers cannot offer adequate collateral, some microcredit providers pool borrowers together to offer a larger loan to the group, which is jointly liable for its repayment. In such circumstances, group members may feel the pressure from their peers to make timely reimbursements of their portion of the loan.

49. Microfinance institutions (MFIs) constitute one key category of microcredit providers. Although most MFIs are designed for small loans to micro borrowers, they are not strictly limited to micro borrowers and may impose different eligibility conditions. Compared with banks, MFIs typically demand less collateral and other guarantees. They also offer more personal, tailor-made and accessible financial products, although they do not necessarily always charge lower interest rates than banks. Loans are often the first product that MFIs offer to clients. Microfinance has made a major contribution to improve microenterprises' access to credit, particularly for businesses run by women. Eight out of every ten microfinance clients in the world are likely to be women entrepreneurs.

50. Generally, less stringent prudential regulations apply to MFIs compared with banks. Microcredit lending is mainly subject to existing laws and regulations governing contracts and dispute resolution, and certain specific laws or regulations concerning the operation of MFIs (if any). Challenges faced by micro-enterprises seeking affordable financing have been identified when exploring legal issues surrounding microfinance. They include: (i) a lack of transparency in microfinance product pricing; (ii) disproportionate collateral requirements, resulting in abusive collection practices by some MFIs; (iii) governance issues such as absence of or poor measures to ensure client protection and prevention of unscrupulous practices; and (iv) poor financial literacy in the community generally.

K. Public financial institutions

51. In many countries, there are public financial institutions (often, albeit not always owned by the State) that supply financial services to underserved groups, including MSMEs, and play an important countercyclical role to mitigate financial markets' crises. Some of these institutions act as commercial banks mandated to directly lend to MSMEs; others are "second-tier" lenders providing funds to commercial banks and other financial institutions that extend credit to MSMEs; yet others combine both

direct and indirect lending functions. One example of these public financial institutions are development banks established by governments (sometime in partnerships with international or private financial institutions) with the aim, amongst others, to provide long-term capital to fill the market gaps left by commercial banks. Besides providing loans to MSMEs, development banks may also provide financial assistance in the form of venture capital funds and guarantees. Further, they can support social and economic growth through investments in social and economic infrastructures.

52. Public financial institutions do not have the same corporate goals and market strategy as commercial banks. For instance, they are not driven by profit maximization which makes them more accessible credit suppliers for MSMEs. For example, to help contain effects of domestic or global financial crisis, in certain countries public financial institutions have offered short-term interest-free delays in repayments of loans; the opportunity to restructure loans with long grace periods; or increased credit limits in particular to those MSMEs that needed to preserve staff employment. Public financial institutions may even play an important role in financing MSMEs as providers of credit for research and development, innovation, exports and good practices on environmental, social and corporate governance. Public financial institutions, however, may be less agile than commercial banks in satisfying MSMEs' applications as they tend to be subject to stricter audit, reporting and documentation requirements. For States, excessive reliance on public financial institutions to support vulnerable market sectors might involve high financial and fiscal costs with risk for domestic financial stability which might discourage certain of them to continue supporting this banking sector.

L. Islamic finance

53. Other forms of financing may be relevant throughout a MSME's lifecycle, such as Islamic financial products offered by financial institutions. Islamic financial products are governed by rules and practices that prohibit interest payments or impose strict limits to the right to charge interest, leading to other forms of consideration for the borrowed money (e.g. profit-sharing or direct participation in the results of the transactions).¹⁶ Islamic financial products can be divided into two broad categories: asset-based and equity-based financial products. *Murabaha* is the most commonly used asset-based financing method for MSMEs, under which the financier purchases assets required by the client and then sells them to the client at a cost that includes a disclosed profit margin to be paid back, usually in instalments. Given the similarities between *Murabaha* and factoring, the *Murabaha* model also makes factoring an acceptable instrument of Islamic finance. Among equity-based Islamic financial products, *Diminishing Musharaka* has been designed as a model under which the entrepreneur promises to buy the investment shares of the other partner(s) over time until the entrepreneur owns 100 percent of the venture. In recent years, Islamic financial products have also been developed in some jurisdictions in the context of crowdfunding and factoring. The *Murabaha* model is the model offered by most crowdfunding platforms in the market.

54. The main challenges for wider use of Islamic financial products for MSME financing include: (i) Islamic financing is not available in all markets; (ii) there is a lack of diversity in offering different financial products to support MSMEs' needs (i.e. the products offered to MSMEs generally concentrate on debt financing such as *Murabaha*, which is more suitable for specific financing purposes while more equity-based Islamic financing could be explored and offered to MSMEs); (iii) transaction costs are relatively high and often only immovable assets can be accepted as collateral; (iv) MSMEs' low Islamic financial literacy, partly because in many countries this industry is still at a beginning stage; and (v) in certain countries, weak

¹⁶ Islamic Development Bank, 2021, Economic Empowerment for Financial Institutions, Islamic Financial Product Implementation Toolkit.

collaboration (e.g. shared capital, risk, training) between public and private sectors that offer Islamic financial products may prevent attracting more stakeholders to participate as capital providers. Moreover, many countries without a tradition of Islamic financing do not have a regulatory framework supporting Islamic financial products. As a result, such products are less standardized, thus making it difficult for banks to market them and for potential customers to understand their terms and conditions. To minimize those risks, many of those products often need to follow non-Islamic banking rules and regulations.

III. Measures to facilitate MSMEs' access to credit

55. Chapter II has highlighted several obstacles to MSMEs access to credit. Some of those obstacles are specific to MSMEs, such as the lack of a reliable credit history affecting especially young entrepreneurs, lack of expertise and skills to produce adequate financial statements, lack or insufficiency of collateral and limited financial or formal education. Other obstacles are not specific to MSME, but may affect MSMEs more severely than larger enterprises.

56. Reform of relevant areas of private or commercial law may help to ease MSME access to credit, as further discussed in this chapter. It will not, however, by itself remove all those obstacles, which may require a combination of regulatory and policy measures. Regulatory and private or commercial law measures to facilitate MSME access to credit should thus be coordinated so as to maximize their positive influence on the lending behaviour of financial institutions. The impact of the general financial sector and related regulation on MSME access to credit should also be considered. For example, in several countries, prudential regulation does not permit financial institutions to accept certain types of movable assets as collateral (e.g. pieces of equipment, raw materials, receivables) and favour instead other types of assets (such as real estate, securities and investment accounts), which MSMEs are less likely to possess. Those regulatory restrictions may render secured lending of lower value assets uneconomical for regulated financial institutions and diminish the positive effect on MSME access to credit. Measures such as current law reform initiatives promote the use of a wide variety of movable assets as collateral (see para. 77) Enhancing coordination between such reforms and prudential regulations would thus incentivize regulated financial institutions to extend credit to MSMEs secured by rights over certain movable assets that could not otherwise be considered.

57. This chapter examines legal, regulatory and policy interventions that help create a legal framework to reduce barriers to MSMEs access to credit such as: enhanced conditions for business formation and registration, and MSME operation; secured transactions law reform to support the used of movable and immovable assets as collateral; issuance of personal guarantees and credit guarantee schemes. Other measures considered in this chapter, which may reduce transaction costs, incurred by financiers when lending to MSMEs, include measures that facilitate assessment of MSMEs creditworthiness, ensure effective enforcement of financiers' rights, and provide adequate mechanisms for resolving disputes. Further measures expected to positively impact MSME access to credit include measures to support MSMEs in financial distress, rules and guidance on fair lending practices, legal facilitation of business in an electronic environment and the promotion of financial literacy. While most of these measures could benefit MSMEs of all sizes, certain measures (for instance public credit guarantee schemes) may be only available to MSMEs that meet certain eligibility requirements.

A. Equal access to credit

58. In order to fully support MSMEs, the legal, policy and regulatory infrastructure should afford all potential borrowers equal opportunities to obtain credit. That is, financial providers should evaluate MSMEs loan requests only on the basis of the applicant's creditworthiness and repayment capacity and not on extraneous grounds such as race, colour, gender, marital status, language, religion, political orientation, national or social origin, property, birth (i.e. place or date – compliance with minimum age requirements would apply), disability or other status. The Guide acknowledges that domestic laws sometimes provide some form of preferential treatment (for example, preferential credit lines or interest rates) to MSMEs owned by entrepreneurs who are citizens of the country. Such preferences may be justified by public interest considerations such as, for example, the promotion of the domestic economy, job protection or support to MSMEs operating in strategic sectors for (e.g. national security). In the interest of transparency and fairness, information on the availability of any such preferential treatment and the conditions for obtaining it should be widely disseminated.

59. Discrimination may take different forms. It may be geared against MSMEs generally, for example, when a bank discourages MSMEs from applying for credit or denies credit without a reason. Discrimination may also be ostensibly or implicitly motivated by a personal attribute of the entrepreneurs or members of an MSME for example when financiers treat certain MSMEs differently from others based on a prohibited ground (for instance by rejecting a loan application despite fulfilment of all the advertised loan requirements or offering disadvantageous conditions even though the MSME qualifies for more favourable terms). Even practices or policies that apply equally to all credit applicants may have a discriminatory effect if they burden or exclude certain MSMEs. For example, establishing a minimum threshold for loans may exclude MSMEs with low-income levels such as those operating in poor areas or owned by minorities. Similarly, reducing bank locations may negatively impact those MSMEs that rely on a local-level banking relationship. To ensure equal credit opportunities for all borrowers, some countries have adopted laws prohibiting discrimination in any aspect of a credit transaction and extended their application to small businesses. Discrimination may also be embedded in the algorithm supporting digital credit scoring models, which may result in bias against certain groups of customers. Laws or regulations prohibiting discrimination should therefore apply also to providers of digital financial services.

60. In some countries, the main victims of this type of discrimination are women-owned MSMEs. Barriers for women entrepreneurs' access to credit result not only from the difficulty to meet the requirements of formal financial institutions, but also from the absence of suitable credit products (as noted in para. 6 women may operate in sectors with low profit margins or run small-scale businesses not profitable for financial institutions) or the lack of an affirmative gender policy by financial institutions to favourably consider women's loan applications. Moreover, credit products are sometimes designed without taking into account possible restrictions in women's legal title to some usual forms of collateral (for example immovable property) or fail to consider more general constraints that women may face in the country, such as the difficulty to present the documents demanded by lenders (see para. 21). Recognizing that women's poverty is directly related to unequal access to economic opportunities, United Nations Member States have expressed their commitment in different forums¹⁷ to undertake legislative and administrative reforms in various areas of their domestic framework and enforce non-discriminatory laws that give women equal access to economic resources, including credit.

¹⁷ See for example the Beijing Declaration and the Platform for Action (1995) adopted unanimously by 189 States and [A/RES/66/288](#) – The Future We Want.

Recommendation 1:

The law should ensure that MSMEs have access to credit without discrimination based on any ground such as race, colour, gender, marital status, language, religion, political or other opinion, national or social origin, property, birth, disability or other status.

Recommendation 2:

The law should ensure that:

(a) Women have equal and enforceable rights to access credit in order to start and operate a business; and

(b) The requirements for access to credit do not discriminate against potential borrowers based on their gender.

B. A legal framework to enhance MSMEs' access to credit**1. Formalization**

61. Many of the obstacles that MSMEs experience in accessing credit are exacerbated by operating in the informal economy. MSMEs without formal status may face difficulties in gaining access to the banking sector and must rely on friends and family support or other informal channels which are rarely a guaranteed source of credit. In several countries, business formalization may be an expensive and burdensome process with entry requirements that micro and small enterprises cannot meet, thus preventing the formalization of many potentially viable businesses. Countries of different legal traditions have introduced simplified legal forms for MSMEs to facilitate their migration to the formal economy. Other countries have promoted formalization by making their system of business registration more user-friendly and time and cost efficient.

62. Domestic laws may use criteria such as the size of the business, or registration with the social security system or tax authority or business registry to establish the boundaries between the formal and informal economy. Consistent with the *UNCITRAL Legislative Guide on Key Principles of a Business Registry (2018)* (the "Business Registry Guide"), this Guide considers an MSME that has not complied with all mandatory registration and other requirements of the jurisdiction in which it is established as operating in the informal economy.

(a) Business formation and registration

63. An efficient legal framework that minimizes the cost and burden of business formation, operation and closure may encourage MSMEs to register, since overly burdensome registration procedures may outweigh the MSME interest in operating in the formal economy. Reliable and easy-to-access business registries are also expected to improve MSMEs' visibility to the public and the market, including potential partners and clients from foreign jurisdictions, and increase their opportunities to obtain financing from regulated financial institutions.

64. To simplify and streamline business registration, the "Business Registry Guide" addresses various aspects of registration from the establishment and operation of the business registry to the cost of its services and the requirements for businesses to register. In keeping with the principle that registration should be as simple as possible, the Business Registry Guide identifies minimum information that businesses should submit without affecting transparency and legal certainty. In the context of access to credit, although the Guide does not recommend that MSMEs submit their financial information to the registry, as it may prove particularly burdensome, it encourages them to do so in a simplified form. Supplying information on, for example, their financial position and capital needs (including profits and dividends), and their

management structure¹⁸ would signal MSMEs' accountability and increase their chances of access to credit.

65. To further encourage MSME registration, the Business Registry Guide also suggests incentives, such as promoting access to credit and government subsidies or programmes for registered MSMEs to foster their growth. Government subsidies or programmes may become particularly important during emergencies (e.g. a pandemic or a natural disaster) or global financial crisis. Experience shows that in several countries unregistered MSMEs are likely to miss out on such benefits.

66. Finally, the Business Registry Guide recognizes the many challenges women entrepreneurs experience to establish their business and the resulting high percentage of women-owned MSMEs operating in the informal economy. It thus specifically recommends that women should have equal and enforceable rights to register their business and the requirements for registration should not discriminate against potential registrants due to their gender.¹⁹ To help States establish a gender-neutral business registration framework, the Guide further recommends the collection of sex-disaggregated data for business registration.

Recommendation 3:

To facilitate access to credit, the law should promote the formation of a business, including MSMEs, in the formal economy by providing for an efficient and simplified system of business registration such as the *UNCITRAL Legislative Guide on Key Principles of a Business Registry*.

(b) Business operation

67. Policies to promote the formalization of MSMEs should not only facilitate their formation and registration. They should also pay attention to easing their organization and operation and adequately protecting their rights. The *UNCITRAL Legislative Guide on Limited Liability Enterprises (2021)* (the "LLE Guide") proposes a flexible and simplified legal business form to achieve those objectives.²⁰

68. The simplified limited liability enterprise proposed in the LLE Guide entails legal personality²¹ of the MSME – a protective measure that MSMEs in several countries cannot enjoy – and separation of its assets (e.g. bank accounts) from the personal assets of its owners. As such, the MSME can access financial institutions in its own name and benefit from business loans and other adequate financial products (e.g. business credit cards) whose conditions are often more favourable than those offered to individual consumers. Legal personality also allows the MSME to be shielded from potential claims by the personal creditors (including financiers) of its owners, which may negatively affect its credit history and scores.

69. An essential consequence of the MSME's legal personality is that its owners enjoy limited liability (i.e. they are not personally liable for the MSME obligations and debts solely by reason of being owners of the MSME).²² The MSME itself is liable to its creditors with all its assets. In the context of access to credit, if financiers are satisfied with the assets the MSME can offer, the owners may not have to offer personal assets as collateral to secure an MSME loan (although they may provide personal guarantees in support of the loan, see para. 103). This might free up resources that the owners may invest in the business or use to support additional loan

¹⁸ *UNCITRAL Legislative Guide on Key Principles of a Business Registry, 2018*, footnote 20, p. 63. The Guide is available in the six official languages of the United Nations at <https://uncitral.un.org/> – section "Texts and Status – Micro, Small and Medium-sized Enterprises".

¹⁹ *Ibid.*, recommendation 34.

²⁰ *UNCITRAL Legislative Guide on Limited Liability Enterprises, 2021*, para. 4. The Guide is available in the six official languages of the United Nations at <https://uncitral.un.org/> – section "Texts and Status – Micro, Small and Medium-sized Enterprises".

²¹ *Ibid.*, recommendation 3.

²² *Ibid.*, recommendation 4.

requests. Limited liability and separation of assets may also make convenient for the owners to lend money to the MSME which reduces dependency from external financiers and may provide for more flexibility in the terms of the loan.

70. A recommendation of the LLE Guide which also facilitates access to credit is that MSMEs must keep certain records concerning their structure, activities and finances. This not only signals transparency and accountability of the MSME but permits it to build a good record of information. Particularly, financial statements and other records of finances (e.g. tax returns or reports) can help access more easily formal financial institutions in the light of the increased credibility of the MSME and reduced costs associated with due diligence or other assessments financial institutions may have to conduct (e.g. information businesses are required to provide information for anti-money-laundering purposes). The obligation of keeping records can also help MSMEs to strengthen their financial literacy and managerial skills.

Recommendation 4:

To facilitate access to credit by enabling MSMEs' participation in the formal economy, the law should provide for simplified organizational forms for MSMEs such as the form recommended by the *UNCITRAL Legislative Guide on Limited Liability Enterprises*.

2. Secured transactions

71. In practice, financiers often subject the extension of credit (including, commercial credit and microcredit of the types discussed in this Guide (see paras. 20 to 23 and 48 to 50, respectively) to the borrower providing adequate collateral to secure its obligation. When a borrower and a lender agree that certain assets (the “collateral”) will be encumbered and thus “secure” the payment obligation, the credit is usually referred to as “secured credit” and the credit transaction as a “secured transaction.” Under such a transaction, in the event of the borrower’s default, the lender may seize, dispose of or foreclose on those assets and apply the proceeds to payment of the borrower’s obligation. In a secured transaction, the collateral can be movable or immovable, tangible or intangible.²³ Secured credit allows businesses to use the value inherent in their assets as a means of reducing the lender’s risk, because creditors have access to the assets as a backup source of recovery in the event of non-payment of the secured obligation. In light of the reduced risk, lenders are more likely to be willing to extend credit or to do so on more affordable terms.

72. For secured transactions to reduce credit risk, however, the legal framework governing secured transactions must enable the creditor to realize on the collateral in an economically efficient manner that provides certainty and predictability. This section discusses possible improvements countries can make to their existing secured transactions regime by referencing relevant international and regional standards and identifying possible areas for future improvements.

(a) Existing international and regional standards

(i) Movable assets as collateral

73. Over the years, UNCITRAL has produced a series of legislative texts dealing with the use of movable assets as collateral, including the *United Nations Convention on the Assignment of Receivables in International Trade* (2001), the *UNCITRAL Legislative Guide on Secured Transactions* (2007), the *UNCITRAL Guide on the Implementation of a Security Rights Registry* (2013), the *UNCITRAL Model Law on Secured Transactions* (2016)²⁴with its Guide to Enactment (2017) and the *UNCITRAL*

²³ The term “collateral” has the same meaning as the term “encumbered asset” used in the *UNCITRAL Model Law on Secured Transactions*.

²⁴ Information on the status of the *UNCITRAL Model Law* is available on the UNCITRAL website, <https://uncitral.un.org>, under the section “Texts and status.” The secretariat updates the relevant webpage whenever it is informed of changes in enactment of the *Model Law*. The secretariat also prepares yearly a document containing the Status of Conventions and Enactments of UNCITRAL

Practice Guide to the Model Law on Secured Transactions (2019).²⁵ These texts also seek to facilitate the ability of enterprises to rely on their receivables to access financing through either the grant of a security right or an outright transfer at a discount.²⁶

a. A secured transaction regime that facilitates access to credit for MSMEs

74. Movable assets (tangible and intangible, present and future) may be the only type of asset that some MSMEs own or expect to own and, thus, are the only assets that would be available to serve as collateral. Yet, some legal systems allow businesses to grant a security right in movable assets only to a limited extent. Even where a legal system allows movable assets to be used as collateral, the rules may be inadequate, outdated, fragmented, complex or unclear. This can create significant uncertainty for the MSMEs. Moreover, creditors may be hesitant to provide secured credit to MSMEs because of shortcomings in the legal framework.

75. Readily available credit at a reasonable cost helps MSMEs grow and prosper. Therefore, a secured transaction regime based on the *UNCITRAL Model Law on Secured Transactions* (the “*Model Law*”) that (i) facilitates the easy creation of security rights in all types of movable assets, (ii) ensures that a security right can easily be made effective against third parties (notably by registering a notice in an efficient and cost-effective public security rights registry), (iii) enables lenders to determine the priority of their security rights when entering into the transaction, and (iv) enables simple and economically efficient realization²⁷ on the collateral in the event of default would greatly assist MSMEs.

76. Firstly, to facilitate credit, it should be easy to create security rights over movable assets. In accordance with the *Model Law*, to create a security right the parties would only need to enter into a security agreement that satisfies the simple requirements of the *Model Law* (art. 6(1)). A person should be able to grant a security right in an asset without having to give possession of the asset to the secured creditor, as the asset may be needed for the operation of the business of the borrower. Moreover, the collateral should not be limited to the MSME’s current assets. Rather it should be possible to create a security right in movable assets that the enterprise may acquire in the future and in all its current and future assets, although the security right in a future asset is of course only created when the enterprise acquires rights in it (art. 6(2)).

77. As regards the types of movable assets which can be used as collateral, the *Model Law* enables an enterprise to grant a security right in almost any type of movable asset, including inventory, equipment, receivables, negotiable instruments and documents, bank accounts, intellectual property and digital assets (although digital assets are not addressed in ad hoc rules in the *Model Law*). As noted above, the *Model Law* also facilitates the ability of enterprises to use their receivables to access financing through an outright transfer at a discount. This feature may be particularly beneficial for MSMEs with very few assets other than receivables. The *Model Law* also enables an enterprise with a limited right in an asset to grant a security right in that limited right even though it is not the owner of the asset, for example, the

Model Laws for consideration by the Commission, The document is available on the webpage “Working documents – Commission” under the corresponding UNCITRAL Commission session.

²⁵ All texts are available in the six official languages of the United Nations at <https://uncitral.un.org/> – section “Texts and Status – Security Interests.”

²⁶ At its thirty-ninth session, the Working Group agreed to include reference to the UNIDROIT Model Law on Factoring if that text was adopted before the completion of the draft Guide. At the date this draft Guide is finalized, the UNIDROIT’s Governing Council has not yet discussed the adoption of the Model Law which is on the agenda of its 102nd meeting on 10–12 May 2023. The Commission might thus wish to consider adding a final sentence to paragraph 73 highlighting that the UNIDROIT Model Law complements and is consistent with the *UNCITRAL Model Law on Secured Transactions* (2016) and the *United Nations Convention on the Assignment of Receivables in International Trade* (2001).

²⁷ The term “realization on the collateral” has the same meaning as the term “disposition of the encumbered asset” used in the *UNCITRAL Model Law on Secured Transactions*.

enterprise may provide as collateral the right to use an asset under a lease agreement or the right to use intellectual property under a licence agreement.²⁸

78. Secondly, given that a security right that is effective only against the grantor²⁹ has little practical value, it should be easy to publicize the existence of a security right and ensure that the security right is effective against third parties in accordance with the *Model Law*. Third parties that may seek to assert a claim against the collateral include other creditors of the grantor, parties to whom the grantor may have transferred the assets, and, if the grantor has become insolvent, an insolvency administrator or the like. The principal method provided in the *Model Law* for achieving third party effectiveness of security rights is the registration of a notice with respect to the security right in a public registry. As it allows the grantor to remain in possession of and to continue to use the collateral, this method facilitates the use of property such as inventory and equipment as collateral.³⁰

79. Thirdly, consistent with the *Model Law*, it should be easy to assess *ex ante* the ranking of competing claims with regard to the collateral with a degree of certainty. The most critical issue for a creditor that is considering extending credit secured by particular assets is the priority of its security right in the event of default and when the creditor seeks to enforce the security right (either within or outside the grantor's insolvency proceedings).³¹ A secured transactions regime that facilitates credit for MSMEs should include clear priority rules that lead to predictable outcomes in any competition between claimants to the collateral, including those that arise in the context of insolvency, and properly protect the interests of all competing claimants.³² As a general rule, the *Model Law* provides that the time of registration of the notice constitutes the basis for determining the priority of a security right, with priority as between parties that have security rights in the same collateral generally determined by the order of such registration.³³

80. Lastly, it should be easy, quick and inexpensive to enforce security rights over movable assets. Generally, as reflected in the *Model Law*, a secured creditor should be able to quickly obtain possession of the collateral and be allowed to realize on it in a variety of ways, including selling the collateral and recovering what it is owed from the proceeds, leasing or licensing the collateral and recovering what it is owed from the rent or royalty payments, or acquiring the collateral in total or partial satisfaction of the obligation secured by the security right.³⁴ In addition, again as reflected in the *Model Law*, a secured creditor should be able to obtain possession of, or dispose of, a collateral not only through a judicial proceeding but also extrajudicially, provided that the rights of the grantor and the grantor's other creditors are adequately protected.³⁵ Extrajudicial enforcement may make it possible for a secured creditor to recover what it is owed more quickly and more efficiently.³⁶ Thus, a regime that permits extrajudicial repossession and disposition is likely to have a positive impact on the availability and the cost of credit.

²⁸ *UNCITRAL Practice Guide to the Model Law on Secured Transactions*, paras. 35 and 36. For a lease that does not function as security right, please refer to the UNIDROIT Model Law on Leasing, 2008.

²⁹ According to art. 2 (o) (i) of the *Model Law* "grantor means a person that creates a security right to secure either its own obligation or that of another person".

³⁰ *UNCITRAL Model Law on Secured Transactions: Guide to Enactment*, para. 124.

³¹ *UNCITRAL Legislative Guide on Secured Transactions*, chapter V, para. 18.

³² *Ibid.*

³³ *UNCITRAL Model Law on Secured Transactions: Guide to Enactment*, para. 143.

³⁴ *UNCITRAL Practice Guide* (supra, footnote 29), para. 305.

³⁵ See also UNIDROIT's work on "Best Practices for Effective Enforcement," which aims at assisting national legislators in addressing issues of enforcement of commercial unsecured and secured obligations. For further information, see www.unidroit.org/work-in-progress/enforcement-best-practices/#1644493658763-89df3b2e-4a80.

³⁶ *UNCITRAL Practice Guide* (supra, footnote 29) para. 304.

b. Key features of an efficient registry system

81. In line with the *Model Law*, modern secured transactions regimes adopt registration of a notice in a security rights registry as the primary method of making a security right effective against third parties without the need for the secured creditor to take possession of the encumbered assets. A well-designed notice registry system would not only provide a simple method of achieving third-party effectiveness and facilitate non-possessory security rights but would also make it simple and inexpensive for potential competing claimants to find out about security rights in assets before entering into transactions with respect to those assets.

82. An efficient registry system should have several key features aimed at facilitating secured transactions and making it easier for MSMEs to gain access to credit. Firstly, it should be a “notice registration” system (rather than a “document registration” system) meaning that the secured creditor need only to provide some basic information for example, the names of the parties and a description of the collateral in the notice and that the underlying security agreement and related documentation need not be registered or even tendered for scrutiny by registry staff. Such “notice registration” system reduces transaction costs and allows the parties to preserve confidentiality of details of their transactions. Secondly, the legal and operational guidelines governing registry services, including registration and searching, should be simple, clear and certain from the perspective of all potential users.³⁷ Thirdly, registry services, including registration and searching, should be designed to be as fast, simple and inexpensive as possible, and accessible to the public, while also ensuring the security and searchability of the information in the registry record.³⁸ Fourthly, registration should be a requirement only for the third-party effectiveness and priority of a security right, not its creation. For creation of a security right over movable assets, as noted above the parties only need to enter into a security agreement that satisfies the simple requirements of the *Model Law*. Fifthly, the information entered in the registry record should be organized and become searchable according to the grantor’s name. This is important to facilitate the use of multiple assets as collateral in the same transaction and is essential considering that most movable assets do not have only one description, which makes a system indexed by asset impractical. Last, but not least, the registration of successive security rights in the same collateral should be allowed.

83. A general security rights registry should also be fully electronic, permitting information to be stored in electronic form in a single database, so as to ensure that the registry record is centralized and consolidated.³⁹ Access to registry services should also be electronic so as to permit users to submit notices and search requests directly over the Internet or via networking systems.⁴⁰ Electronic access to registry services helps to eliminate the risk of registry staff error in entering the information into the registry record. It also facilitates speedier and more efficient access to registry services by users, and greatly reduces the operational costs of the registry, leading to lower fees for registry users.

Recommendation 5:

To enable MSMEs to utilize movable assets as collateral:

- (a) The law should provide for a modern and comprehensive secured transactions regime in accordance with the *UNCITRAL Model Law on Secured Transactions*;
- (b) The secured transactions regime should:
 - (i) Facilitate the easy creation of security rights in movable assets;

³⁷ *UNCITRAL Guide on the Implementation of a Security Rights Registry*, para. 10.

³⁸ *Ibid.*

³⁹ *UNCITRAL, Model Law on Secured Transactions Guide to Enactment*, para. 145.

⁴⁰ *Ibid.*, para. 146.

- (ii) Provide for the creation of a security right in future assets;
 - (iii) Ensure that a security right can easily be made effective against third parties by registration of a notice;
 - (iv) Enable financiers to determine the priority of their security rights when entering into the transaction by reference to the registry; and
 - (v) Enable simple and economically efficient realization on the collateral in the event of default; and
- (c) The secured transactions regime should apply to all transactions in which movable assets are provided as collateral to secure payment or other performance of an obligation, including those in which the financier retains title to an asset or is transferred title to an asset in order to secure an obligation.⁴¹

(ii) *Immovable assets as collateral*

84. As mentioned earlier, under a secured credit, the creditor's exposure to the MSME borrower payment default is reduced in proportion to the value of the asset given as collateral. This increases lenders' readiness to finance MSMEs. Where the collateral is an immovable asset, the borrower's title to the asset needs to be formally recognized by a property rights system, which in many countries is manifested and only becomes effective by the execution of a number of formal legal acts.

85. While there are no global legislative standards on the use of immovable property as collateral equivalent to those prepared by UNCITRAL on the use of movable asset as collateral, the Core Principles for a Mortgage Law,⁴² a regional standard developed by the European Bank for Reconstruction and Development (EBRD), can provide useful reference in respect of key features of an efficient legal framework.

a. Legal recognition of property rights over immovable assets

86. In several countries, lower-income segments of the population (including micro and small entrepreneurs) lack formal recognition of their rights over immovable assets they use for housing or business purposes in both urban and rural areas. Lack of proper title or inefficient registration systems could make granting security right over immovable assets impossible or very expensive for MSMEs. This is also particularly relevant in the context of microenterprises in the agricultural sector that often cultivate and use land for which they have no formal ownership title. As a result, they often cannot offer the land as collateral to obtain credit. Sometimes they may not even be able to offer movable assets attached to or placed on the land (e.g. growing crops and machinery) as collateral because the law treats such assets as part of the land. In some countries, financiers may accept a simple certificate of customary interests and rights in land (rather than a formal ownership certificate) as collateral. Recent land reforms, for example, required the establishment of special agencies to keep accurate records of transactions related to customary land and to provide a list of existing customary interests and rights in land. In addition, discriminatory laws (e.g. inheritance) in some countries may be biased towards men, which restrain the ability of women to own land that could be used for collateral.

⁴¹ The Commission may wish to consider the following revisions to the recommendation:

- (i) subparagraph (b) (iv): replacing "financiers" with "parties" since financiers may not have a security right and clarifying whether the phrase "by reference to the registry" intends to indicate priority in time of the security right in respect of other registered security rights; and
- (ii) subparagraph (c) replacing the final part ("including those ... secure an obligation") with "regardless of whether the parties have denominated it as a security right, and regardless of the type of asset, the status of the grantor or secured creditor, or the nature of the secured obligation".

⁴² The Core Principles for a Mortgage Law are available on the website of the European Bank for Reconstruction and Development (EBRD) at www.ebrd.com/home.

87. There are various land tenure contexts across the world which result from a combination of policy and legal choices as well as culture, history, religions and gender dynamics. There are many systems of land tenure ranging from rights formally recognized by a country's legal system to unrecognized rights of customary origin. The extent of legal certainty provided to owners varies greatly depending on the owners' ability to effectively enforce their rights and the availability of dispute resolution methods for that purpose. Title deed and formal recording of tenure rights in property registries is the preferred system for ensuring tenure security, but there are also less costly and expeditious procedures such as "fit for purpose" land certification systems,⁴³ recognition of community forest rights and community-based management of land.

88. Adopted by the United Nations General Assembly in 2018 (A/RES/73/165), the United Nations Declaration on the Rights of Peasants and Other People Working in Rural Areas calls upon States to "take appropriate measures to provide legal recognition for land tenure rights, including customary land tenure rights not currently protected by law, recognizing the existence of different models and systems." The Declaration also stresses that peasant women and other rural women play a significant role in the economic survival of their families and in contributing to the rural and national economy but are often denied tenure and ownership of or equal access to land. In this respect, it should be noted that the Commission on Legal Empowerment of the Poor listed, as a legal empowerment measure, promoting an inclusive property rights system that will automatically recognize immovable assets bought by men as the co-property of their wives or partners.⁴⁴

b. Key features of an effective legal framework

89. Facilitating access to credit could be regarded as the primary objective of modernizing the legal framework for secured transactions involving immovable assets. In this respect, the general objectives of the *Model Law* to enable the use of movable assets as collateral can equally apply to a regime on immovable assets.⁴⁵ However, the immovable property law involves specific policy considerations that may be different from those applying to moveable assets. While in some countries the rules governing the creation, validity and enforcement of security right apply to both movable and immovable assets, other countries have adopted a system with specific types of security right for specific assets. For example, in contrast to rules governing the creation of security rights on movable assets, the creation of a security right on immovables is generally limited to existing assets, not future assets. In addition, immovable property registries are in several respects different from movable property registries as they (a) are asset-based, not debtor-based; and (b) involve document registration, not notice registration. Moreover, registration in immovable property registries is a necessary condition for creating a security right against all and it is not simply a means for making it effective against third parties. Nevertheless, the functional approach adopted by the *Model Law* can arguably be adapted to the context of immovable assets. Thus, an effective legal framework for secured transactions involving immovable assets should apply to all transactions under which a property right is created over immovable assets to secure payment or other performance of an obligation, regardless of whether the parties have denominated it as a security right.

90. Furthermore, an effective secured transaction regime involving immovable assets should include at least the following three key features as recommended in the

⁴³ In such systems, the approach used for building land administration systems in less developed countries should be flexible and focused on serving the purpose of the systems (such as providing security of tenure and control of land use) rather than focusing on top-end technical solutions and high accuracy surveys. See Joint International Federation of Surveyors and World Bank, *Fit-For-Purpose Land Administration*, 2014, p. 10.

⁴⁴ Commission on the Legal Empowerment of the Poor, *Making the Law Work for Everyone* (volume II), 2008, page 92.

⁴⁵ Encumbrances on immovable assets are, in principle, excluded from the scope of the UNCITRAL texts on secured transactions because they raise different issues (e.g. subject to a special document registration system and indexed by asset, not by grantor).

EBRD Core Principles for a Mortgage Law. Firstly, the law should at least enable the expeditious creation of a proprietary security right at a reasonable cost without depriving the person giving the mortgage of the use of his/her property.⁴⁶ Accordingly, it should be possible to create a mortgage (a) over all types of immovable assets, (b) to secure all types of debts, and (c) between all types of persons. In addition, the parties should be able to adapt a mortgage to the needs of their particular transaction in compliance with the mandatory norms of the applicable legal system. As noted earlier, norms concerning immovable assets have their own specificities and in many countries the creation of a security right over an immovable asset often requires various formalities (such as the execution of a public deed, notarization of conveyance documents and registration in the land registry) that are not required for most categories of movable assets. In this way, ease in creating a security right over immovables should not mean abolishing justified formalities or extending to immovable collaterals the same rules applicable to movable ones.

91. Secondly, enforcement procedures should enable prompt realization at market value of the mortgaged property. Delays in realization are likely to bring uncertainty and increase costs. Any surplus proceeds beyond those needed for satisfying the secured claim should return to the mortgagor.⁴⁷

92. Finally, the law should establish rules governing competing rights of persons holding mortgages and other persons claiming rights in the mortgaged property.⁴⁸ For mortgages, in most countries they are registered in the same registry as the title to the property so that anyone searching the title can see the mortgages immediately. While registration is intended to “authenticate” the mortgage in most traditional systems which requires the registrar to conduct his/her own enquiry or to rely on notarization that the mortgage has been validly created, the registration process could be simpler and quicker if registration is merely intended to publicize the mortgage claim.

Recommendation 6:

The law should provide for a secured transactions regime with respect to immovable assets which enables the parties to:

- (a) Create security rights over immovable assets;
- (b) Realize security rights over immovable assets; and
- (c) Determine the priority of the secured creditor’s rights when entering into the transaction.

(b) Addressing concerns about overcollateralization

93. Despite the obvious advantages of a legal framework for secured transactions based on the *Model Law*, this by itself may not remove all obstacles that MSMEs may face in obtaining access to credit, such as issues concerning over-collateralization.

94. Sometimes, financiers require micro and small enterprises to provide collateral, the value of which significantly exceeds the amount of the loan (a practice often referred to as “overcollateralization”),⁴⁹ either because of uncertainty as to the amount that may be realized from the collateral in the event of default or because a financier with greater bargaining power insists on a higher-value collateral. While the financier usually cannot claim more than the amount of the secured obligation and expenses incurred with enforcement, overcollateralization may limit businesses from utilizing the maximum value of their assets and obtaining secured credit from another financier using the residual value.

⁴⁶ *EBRD, Core Principles for a Mortgage Law*, Principle 2.

⁴⁷ *EBRD, Core Principles for a Mortgage Law*, Principle 4.

⁴⁸ *EBRD, Core Principles for a Mortgage Law*, Principle 9.

⁴⁹ In practice, overcollateralization may be in combination with requests for issuance of personal guarantees.

95. The *Model Law* offers an option for States to require the maximum amount for which the security right can be enforced in the security agreement (art. 6(3)(d)). A State's decision to enact this option will depend on what it considers to be the most efficient financing practice and on reasonable expectations of local credit market participants. The rationale for this option is to facilitate the grantor's access to secured credit from other creditors in situations where the value of the collateral exceeds secured obligation.

96. As noted by the World Bank,⁵⁰ the existence of a secondary market where assets provided by the micro and small enterprises as collateral can be traded would permit financiers to assess their value more accurately and facilitate the financier's decision as to whether to extend credit on the basis of that collateral, how much credit to extend, and at which interest rate. Thus, the existence of secondary markets (as the existence of a robust public auction ecosystem) would also allow financiers to realize on the collateral more easily, increase their readiness to extend credit to MSMEs and possibly help to reduce their collateral requirements in those transactions. This would be of critical importance to micro and small enterprises since the assets they can offer as collateral might often be difficult to value. In any event, it would be important to establish some basic safeguards to ensure that these markets operate in accordance with transparent pricing mechanisms. In this respect, the *Model Law* sets out a general obligation for any person exercising its rights and performing its obligations under the *Model Law* to act in good faith and in a commercially reasonable manner (art. 4). It should be noted, however, that even when secondary markets exist the financier may not always be able to recover the expected market value as the realizable value may be affected by deteriorating market conditions. In cases where assets need to be disposed of urgently, buyers often expect to acquire them at a substantially lower price.⁵¹

97. Finally, the availability of independent appraisal mechanisms for financiers may also contribute to mitigating the phenomenon of overcollateralization. Better asset valuations enable more accurate estimates of how much can be realized from the collaterals in the event of default. This, in turn, may lead lenders to adjust collateral requirements to the necessary margin and potentially reduce overcollateralization.

3. Personal guarantees

98. A personal guarantee is a promise by a third party to fulfil the obligations of a debtor to a creditor. The existence of such a guarantee can increase access to credit in two ways. First, if the guarantor is able to satisfy the obligation, this can lower the creditor's risk of suffering a loss as a result of the debtor's default and, thus, may enable the extension of credit to the debtor where it would not otherwise be available, or lower the cost of that credit, even where the debtor is unable to supply sufficient collateral to bring about those benefits under the applicable secured transactions regime. Second, the prospect of the guarantor being liable for the debt will often provide the guarantor with an incentive to assure that the debtor satisfies its debt so that the guarantor will not have to do so.

99. Personal guarantees permit MSMEs to secure financing that would otherwise be out of reach for many of them. Financiers may not be prepared to lend money to a MSME without a guarantee of performance by a reliable third party because the risk of loss from the MSME's default would be relatively too high for the financier to bear. Although they should not replace a proper credit risk analysis, personal guarantees incentivize financiers to extend credit to MSMEs – often at more affordable conditions such as a lower interest rate, a larger loan amount or a longer repayment term. This can support and further improve MSME's competitiveness on the market.

⁵⁰ World Bank, *Secured Transactions, Collateral Registries and Movable Asset-Based Financing* (2019), p. 40.

⁵¹ *UNCITRAL Practice Guide* (supra, footnote 29), para. 122.

(a) Types of personal guarantees

100. The guarantor's obligation can be either "independent" or "dependent" from the underlying transaction between the creditor and the principal debtor. Under the first category (which includes, for example, standby letters of credit), the guarantor/issuer promises to pay the beneficiary upon a demand for payment. The demand may, depending upon the terms of the undertaking, be either a "simple" demand or one having to be accompanied by the other documents called for in the guarantee or standby letter of credit. The guarantor/issuer's obligation to pay is triggered by the presentation of a demand for payment in the form, and with any supporting documents, as may be required by the independent guarantee or standby letter of credit. The guarantor/issuer is not called on to investigate the underlying transaction but is merely to determine whether the documentary demand for payment conforms on its face to the terms of the guarantee or standby letter of credit. Thus, the beneficiary need not demonstrate the debtor's failure and has the right to payment either upon simple demand. Mature medium-sized enterprises active in cross-border transactions may prefer independent guarantees, which are effective in building the MSME creditworthiness, as they can afford their additional cost (these guarantees are usually provided by financial institutions given their considerable level of risk). In many countries, independent guarantees are not specifically regulated by law and are mainly created through contract practice. The *United Nations Convention on Independent Guarantees and Stand-by Letters of Credit* (New York, 1995)⁵² may assist States in developing an effective legal regime that applies to those guarantees. The *Convention* supports the use of general conditions or usages such as the Uniform Rules on Demand Guarantees and the Uniform Customs and Practice for Documentary Credits (prepared by the International Chamber of Commerce and endorsed by UNCITRAL,⁵³ see para. 43) that the parties may wish to incorporate in the guarantee.

101. Under dependent guarantees (also known as suretyships), the guarantor acts as a secondary obligor for the principal debtor in case of default, since its obligation is accessory to the debtor's main obligation. Therefore, in most jurisdictions the creditor must request repayment from the principal debtor first, and the guarantor, once requested to pay, can refer to all defences that the principal debtor has against the creditor. Dependent guarantees are usually provided by non-professional guarantors who are typically the owners of the MSME, if the MSME is incorporated, their family members or other related persons.

102. In certain jurisdictions, there may be an additional type of personal guarantees that combine features of independent and dependent guarantees. Such guarantees are often available only to natural persons acting in their professional capacity and businesses of all sizes and forms and provide them with greater contractual freedom. For example, parties can have the ability to guarantee (current or future) specific payment obligations or determine the extent to which the guarantor can waive its rights for recourse. Such instruments may also allow for references to the guaranteed obligation without the risk of being requalified as a suretyship.

(b) Suretyships for MSMEs

103. A request for personal guarantees may be more common when the MSME does not dispose of assets to offer as collateral at the level required by the financiers' risk assessment. Financers may also demand personal guarantees even when the collateral provided by the MSME is commensurate with the risk they assume in order to further

⁵² The *Convention* is available in the six United Nations official languages at <https://uncitral.un.org>, section "Texts and Status – International Payments".

⁵³ For the endorsement of the *Uniform Customs and Practice for Documentary Credits* (UCP 600), see *Official Records of the General Assembly, Sixty-fourth Session, Supplement No. 17* (A/64/17), para. 357. For the endorsement of the *Uniform Rules for Demand Guarantees* (URDG), see *Official Records of the General Assembly, Sixty-sixth Session, Supplement No. 17* (A/66/17), para. 249.

reduce it. In this regard, personal guarantees provided by the owner can supplement the security rights granted by the MSME and they may also reduce the need to offer additional business assets as collateral. Indeed, the personal assets of the owner could be equal to or of greater value than those of the MSME, in particular if the MSME is a start-up. From the perspective of the financiers, personal guarantees provided by the owner would also be a positive signal of the MSME commitment to repay the loan.

104. Financiers might expect the same level of commitment when a family member (often the spouse) or a friend provides the guarantee given their strong personal ties with the MSME owner. Family members or friends of the entrepreneur, however, may grant a personal guarantee against their better judgment or under an emotional influence, without sufficient knowledge of the implications or the MSME financial situation, thus putting their personal assets at risk. Some countries have laws intended to limit risks of over-indebtedness or attachment of the personal property of family members or other vulnerable guarantors, such as, for example persons subordinate to or otherwise dependent on the MSME. In some countries, courts protect vulnerable guarantors by applying the general doctrines such as violation of fiduciary relationship, unconscionability or undue influence, the application of which is not limited to personal guarantees. In other countries, the courts have held that it is illegal for a financier to require a spousal guarantee for the sole reason that the prospective guarantor is married to the person seeking the loan.

105. Although issuing a personal guarantee is common for many MSMEs across different regions of the world, personal guarantees may run counter the objective of statutory limitation of liability for incorporated MSMEs since either the owner or a family member will become personally liable for the MSME's debts. As noted earlier, the default of an MSME may cause severe financial problems for the guarantors and their households. In certain countries, surety bonds may provide an alternative to guarantees for MSMEs engaged in certain commercial sectors in which guarantees are usually required (for example construction or public procurement). Surety bonds are tripartite financial agreements by which one party (the surety) guarantees that another party (the principal, i.e. the party that purchases the bond) will honour its contractual obligation towards the beneficiary (obligee). If the principal fails to perform the obligation, the surety, which is usually a professional issuer, will pay to the obligee an agreed amount, as set out in the bond itself and in line with the underlying contract between the obligee and the principal. Similar to personal guarantees, surety bonds can enhance financial protection for financiers and other third parties dealing with MSMEs, but in contrast to personal guarantees they are issued for a fee which may make them mainly viable for mature medium-sized enterprises that can have the necessary financial resources to pay for this service. Surety bonds permit MSMEs to enhance their working capital and liquidity to finance their activities. Moreover, surety bonds can help MSMEs to gain contracts as they provide the other party with the security of contract performance. In certain countries, surety bonds are presented as cheaper tools for MSMEs than guarantees. In other countries, the relatively high rate of premiums charged by private companies for issuing the bonds makes them inadequate for small businesses.

Key features of a personal guarantee regime

106. While some countries have enacted legislation on personal guarantees for small business loans, most countries do not provide a specific regime and general laws on contractual guarantees apply. Nevertheless, several elements of those general laws, such as protection of guarantors or rights and duties of parties to the guarantee agreement, are equally relevant for guarantees provided for small businesses' loans. Given the differences among domestic laws, the following paragraphs do not prescribe rules on personal guarantee but simply outline certain features of a legal regime that protects the guarantor and at the same time provide certainty to all parties of the agreement.

a. Form of the personal guarantee

107. It is important in particular for unexperienced guarantors to properly assess their risk exposure when agreeing to assume the obligation to repay the MSMEs' debts. In most jurisdictions, the law reminds the guarantor of the significance and implications of its obligations by imposing certain formal requirements for the enforceability of the guarantee, such as written form and the guarantor's signature. With a view to further reducing the risks associated with the guarantor's information deficit, in certain jurisdictions the laws establishes additional conditions such as an explicit declaration of responsibility by the guarantor (i.e. the use of phrases such as "I guarantee" or "I accept responsibility" with the guarantor's signature appearing directly under them) or notarized documents (which may include an explicit limit of the amount of a guarantee for the guarantor to realize the risk at stake).

b. Rights and obligations of the parties

i. *Pre-contractual and contractual disclosure of information*

108. In several countries, financiers are required to explain to the guarantor the conditions of the guarantee, for example: whether it is limited (by amount or time); the general legal and economic risks assumed by the guarantor, including whether the beneficiary acquires a security right on the assets of the guarantor; whether the guarantee covers the financier's fees and expenses associated with either the underlying obligation, the enforcement of the guarantee, or both. Additional information important for the guarantor to properly assess the financial risks of the guarantee may include information on the existence of any security right granted by the MSME in support of the main obligation, and the MSME financial conditions, such as its assets and any debts. The fact that certain information may be confidential does not affect the duty to inform, as the financier should obtain the MSME's consent for disclosure. General principles of fair contract practices (see para. 169), require information to be provided in a way that it is understandable and the terms of guarantees to be comparable to the terms applied by other financiers.

109. A guarantor that has personal ties with the MSME (e.g. the guarantor is a member of the owner's family or a friend) may assume greater risks as a result of such close relationship to the business. For example, in some countries, insolvency law treats the claims of family member guarantors against the insolvent MSME as subordinated to the claims of other classes of creditors. To ensure that guarantors understand the potential risks of the guarantees, in certain countries financiers must recommend guarantors to seek independent legal and financial advice on the effects of the guarantee. In some countries, financiers are also required to ascertain that guarantors with personal ties with the MSMEs have received independent legal advice.

110. In several countries, guarantors are reminded of the long-term nature of their commitment and allowed to monitor their risk exposure by receiving regular communications during the guarantee period about the state of the guarantee, including on the evolution of the main obligation and any other ancillary obligations linked to it (see para. 115). When introducing such periodic information disclosure requirements, regulators would be well advised to bear in mind their impact on transaction costs and on the overall cost of credit. For example, while some information may be required to be provided for free at reasonable intervals (annually, for instance), financiers may be entitled to charge reasonable fees for additional reports requested by guarantors.

111. To enhance its effects, the duty of disclosure can be complemented by a risk-warning duty, so that the guarantor is notified of any circumstances that may trigger the guarantee, such as the MSME's default. In certain jurisdictions any change in the terms of the underlying obligation that is detrimental to the guarantor, is not enforceable without the guarantor's express consent.

ii. Nature and scope of the liability

112. When the nature of the guarantor's liability is subsidiary, the financier must first demand performance from the MSME before calling on the guarantee. If, however, solidary liability of the guarantor is established, the financier can claim performance from either the MSME or the guarantor within the limit of the guarantee. Protection of the guarantor would advocate for the law to specify whether a presumption of subsidiarity or solidarity exists and whether the parties can modify such presumption and, if so, by which means (whether by an explicit agreement or by conduct). The requirement of an express agreement on the nature of the liability may not suffice to protect a guarantor in a weak bargaining position against demands by the financier to assume several joint liability for the debt. When more than one personal guarantor secures the performance of the main obligation under a joint and several liability clause, guarantors may not realize that, in such cases, the financier may recover the full amount of the debt from any of the guarantors, leaving that guarantor to try to recover a share of that payment from the other guarantors.

113. A subsidiary liability, may also by itself not suffice to protect the guarantor against unwarranted payment demands, for instance where the financier fails to undertake appropriate attempts to obtain performance from the principal debtor. To mitigate such risk, it is good practice for the law to specify the types of remedies against the principal debtor that need to be exhausted before requesting the guarantor's performance. Such remedies could include, for example, written notices, out of court demands, suing the debtor in court or failed enforcement.

114. As to its scope, a guarantee could cover only a particular loan, but it could also cover future loans, for instance under a revolving line of credit. A guarantee that is not limited to a single loan may be particularly risky for a guarantor who may become liable for multiple MSME's loans with the same financier without realizing that its personal liability is increasing. Moreover, when the guarantor is the MSME owner, it might also be held liable for loans taken by the MSMEs even after the business has been transferred to another entrepreneur. Many countries allow unlimited guarantees (in certain countries, unlimited liability is allowed only in commercial relationships), while others only permit guarantees with a certain maximum amount. To mitigate risks for the guarantor, domestic laws can clarify whether limited and unlimited guarantees are permitted, and specific requirements apply (e.g. an explicit agreement between the financier and the guarantor) in the case of unlimited guarantees.

115. Lastly, the guarantor's liability might also cover accessory obligations, such as interests accrued under the main obligation, damages for non-performance by the principal debtor, costs of legal remedies for the financier against the principal debtor. Pre-contractual disclosure of information may not be sufficient to ensure that the guarantor understands the effects of such additional obligations the guarantee will cover (see para. 108). It may thus be advisable that additional and specific mechanisms are in place. For example, in certain countries the cost of legal remedies is not covered by the guarantor unless there is an agreement between the parties. The guarantor might also have contractual defences (e.g. extension of time on principal debtor's obligation) not available to the principal debtor. For the purposes of clarity, the law may identify them and specify if such defences can be waived and to what extent.

Recommendation 7:

To help ensure that MSME guarantors and financiers are aware of their rights and obligations, the law should:

- (a) Provide that the terms and conditions of the guarantee are clear, understandable and legible; and
- (b) Identify both the formalities and content requirements necessary to make a guarantee effective.

4. Credit guarantee schemes⁵⁴

116. Many countries offer credit guarantee schemes as a key policy tool to address the financing gap of MSMEs and in particular of micro and small enterprises, which are usually their main beneficiaries. Such schemes lower the lending risk for financial institutions by guaranteeing partial or full repayment of the loan taken by the MSME in case of its default, usually in return for a fee paid by the financial institution or MSME or both. Payment of the defaulted loan entitles the entity providing the credit guarantee to claim reimbursement from the MSME (see paras. 127 to 130). Credit guarantee schemes also facilitate MSME access to formal credit, since they either eliminate or alleviate the need for collateral, which an MSME may not have, thus improving the terms of the loan.

117. The Organisation for Economic Co-operation and Development (OECD) describes four major types of credit guarantee schemes: (i) public credit guarantee schemes where the guarantee is paid out directly from the government budget, which gives the scheme high credibility within the banking sector; (ii) corporate guarantee schemes, which are usually established by the private sector (for instance, professional or industry associations) and generally involve the banking sector; (iii) mutual guarantee schemes, which are private and independent organizations formed and managed by MSMEs with limited access to bank loans; and (iv) international schemes established by bilateral or multilateral government initiatives or initiatives of international or regional organizations, including global and regional development banks (such as the World Bank, the Asian Development Bank, the African Development Bank), which often combine a guarantee fund with technical assistance programmes. In several countries, export credit guarantee schemes have also been established to support businesses, including MSMEs of all sizes and types, trading across borders. Such schemes may have different natures ranging from State-owned institutions (e.g. banks) to public-private partnerships. Given the purpose of this Guide, the following paragraphs focus on public credit guarantee schemes, although some considerations may also be relevant for other types.

118. Public credit guarantee schemes are one of the main public support mechanisms to facilitate MSMEs' access to credit. Other mechanisms with a similar scope include direct lending programmes, facilities for pledging the proceeds of MSME loans as collateral against refinancing from central banks, tax and interest rate subsidies. Different objectives may motivate those State interventions, for example closing the financing gap of MSMEs, improving the productivity and welfare of certain entrepreneur groups, or supporting employment. National or international financial crisis or other extraordinary events that negatively affect the capacity of the market to supply credit to MSMEs are often the main motivating factor behind a State's direct support to MSMEs. Despite these general advantages, in some countries the cost of public credit guarantees is considered to outweigh the benefit of the loan to MSMEs.

119. Public credit guarantee schemes or other public support mechanisms may, however, create market distortions, especially where there is a functioning market for MSME lending, for example by channelling funds to unproductive MSMEs, prolonging the existence of MSMEs that should be liquidated or preventing the diversification of financing sources. Thus, they are not substitutes for efficient market-based lending. Public credit guarantee schemes also entail a number of risks, such as: disadvantaging MSMEs that are ineligible to access the guarantee schemes; disincentivizing financial institutions to carry out proper due diligence, especially when the credit guarantee scheme covers the full amount of the loan loss; giving rise to improper use of taxpayers' money which funds such guarantee schemes; and discouraging micro and small enterprises from growing into medium-sized enterprises given that they may no longer be eligible for public credit guarantee schemes. To avoid such risks and maximize their benefits, it may be advisable to use public credit guarantee schemes and other public support mechanisms as

⁵⁴ The Commission might wish to consider revising the heading as "Public credit guarantee schemes" in line with the focus of paragraphs 118 to 130.

supplementary measures to market-based lending intended to close a financing gap that private lending mechanisms cannot satisfy.

(a) Eligibility

120. Efficient credit guarantee schemes rely on clear and transparent eligibility criteria concerning MSMEs, lending financial institutions and loans that should be publicly available and regularly reviewed. Transparency and clarity of such criteria also help the State to avoid improper use of the public funds invested in the operation of the credit guarantee scheme. While upholding transparency and clarity, States should nevertheless enjoy some flexibility to broaden the MSME eligibility criteria in case of financial crisis or other emergencies that have an impact on the domestic economy so that a larger number of MSMEs can benefit from the scheme. Transparency and clarity would also guide the operations of the credit guarantee scheme. Consistent with such principles and the applicable legal and regulatory framework, credit guarantee schemes could establish programmes dedicated to subclasses of firms or create a list of ineligible MSMEs on the basis of certain criteria that should also be publicly available.

121. Clear eligibility criteria for lending financial institutions could reflect objective indicators such as their capacity in serving small businesses and their risk management capabilities. Typically, eligible financial institutions include commercial and development banks, licensed credit institutions or supervised non-bank financial service providers, credit cooperatives, or not-for-profit entities with the primary purpose of supporting small businesses' development. The possibility to include other categories of eligible financial institutions would help countries to address the need for quick provision of liquidity during major natural disasters or financial crisis.

(b) Mitigating risks to the financial system

122. Public credit guarantee schemes may expose the State to a subsidiary fiscal risk since the entity providing the guarantees may lack the necessary funds to service the obligations arising from invoked guarantees, in particular in times of crises. It would thus be important that for the policymakers involved in the decision to establish a credit guarantee scheme consider the fiscal risks associated with the scheme and possible budgetary and other measures to mitigate the State's contingent liabilities.

123. When designing the credit guarantee scheme, States may use different mechanisms to mitigate the risks of its functioning. For example, they can require the MSME to supply collateral as it demonstrates its commitment to repayment. However, the implications of such policy need to be carefully considered, since excessive collateral requirements can defeat the purpose of the guarantee. The institution responsible for the credit guarantee scheme and the lending financial institution could jointly assess the risk of default and establish the commensurate collateral requirement at a level that does not disincentivize MSMEs to apply for loans.

124. One common way to limit the risk of moral hazard of the lending financial institutions is to establish partial guarantees using the coverage ratio to determine the percentage of the loan exposure that is guaranteed by the credit guarantee scheme. These mechanisms require careful design so that they can afford adequate protection to the lending financial institutions in the event of MSME default, while encouraging them to regularly monitor the MSME performance. For example, a high coverage ratio can be attractive to lending financial institutions, but may provide no incentive to engage in proper risk screening and monitoring activities thus leading to excessive risk-taking and endangering the schemes' sustainability. On the contrary, if the credit guarantee scheme bears only a small share of the risk, the scheme may be unattractive for financial institutions. Policy needs would usually drive the decision of the State on the coverage ratio. A balanced risk sharing between the credit guarantee scheme and the lending financial institution would certainly incentivize this latter to accurately monitor the MSME's credit performance.

(c) Fees

125. The fee charged for the guarantee is usually established in the legal or regulatory framework of the credit guarantee schemes rather than on a case-by-case basis, usually by having a fixed flat fee or a variable one. Since fees may depend on the size of the loan, countries may decide to set a cap to the size of individual loans guaranteed under the guarantee scheme.

126. Transparency of the pricing policy helps make the credit guarantee scheme attractive to its potential users. When determining the fees, it is good practice to strike a balance between the goals of the guarantee scheme and its financial sustainability. Fees, along with the income that the credit guarantee scheme may derive from its investment activities and any government subventions, should cover the cost of the operations and losses the credit guarantee scheme may incur. Both the ceiling, if any, of the fees and the methods for calculating and adjusting them should be flexible enough to respond to downturns in conjuncture or other changes in the country's economic conditions. For example, in times of severe crisis, some States have introduced caps on the amounts of fees that can be charged or have suspended the charging of fees so as to alleviate the impact of the crisis on the financial situation of MSMEs benefiting from credit guarantees.

(d) MSME default and loan loss recovery

127. A timely and transparent process to manage MSME default and subsequent claims from the lending financial institutions is key for an efficient operation of a credit guarantee scheme and is essential to build and maintain the confidence of the lending institutions under the scheme. The legal or regulatory framework and the contractual arrangements clarify the precise circumstances that prompt payments under the credit guarantee scheme, for example the opening of insolvency proceedings against the MSME or other events of default, such as late or partial repayment of the loan, loss or depreciation of collateral.

128. Clear and transparent payment procedures of the guarantee can avoid costly disputes between the lending financial institutions and the credit guarantee schemes. Contractual agreements between the institution responsible for the scheme and the participating financial institution stating the conditions for making claims, the maximum amount of unpaid interest covered by the guarantee and a time limit for the settlement of claims are a preliminary step to preserve a healthy relationship between these two parties. A common practice is to specify a minimum mandatory waiting period before a claim can be made to a credit guarantee scheme after loan disbursement, and it has been suggested⁵⁵ that the maximum period after a missed payments should also be specified and should not be conditional on initiating legal action against the MSME. In addition, it is advisable that the agreements require a detailed written explanation if the claim is refused.

129. Finally, clarity is required in relation to the credit guarantee scheme's rights once it has paid the guarantee. The general legal principle is that the rights or claims of the lending financial institution against the MSMEs or other obligors are assigned to the credit guarantee scheme (statutory subrogation). To ensure that all parties are apprised, it is important that the subrogation right be explicitly set out in the terms and conditions of the guarantee and that the provision clearly stipulate that the credit guarantee scheme can exercise such right without waiting for the financial institution to receive payment of any other amounts not guaranteed. The recognition of a legally enforceable subrogation of the public credit guarantee scheme is a necessary prerequisite for effectively allowing the institution responsible for the credit guarantee scheme to step in the contractual position of the lending financial without the need for a separate assignment of the latter's rights.

⁵⁵ The World Bank and FIRST Initiative, 2015, Principles for Public Credit Guarantee Schemes for SMEs, p. 22.

130. If the credit guarantee scheme provides only partial guarantees, both the scheme and the lending financial institution may have a claim against the defaulted MSME. For improved efficiency, the contractual agreement might specify whether the financial institution or the credit guarantee scheme or both are responsible for debt recovery from the MSME. To maximize the results, it may be convenient for the credit guarantee scheme to entrust the financial institution with this task, since financial institutions typically dispose of various tools to obtain information about their customers and potentially strong incentives to recover the debt. In certain States the lending financial institution is even required to act as the agent of the credit guarantee scheme during the enforcement stage.

5. Assessment of MSMEs' creditworthiness

131. The crucial element of any lending agreement is the financier's decision on whether or not to extend credit to the borrower. Prudent management requires that financiers properly assess the borrower's creditworthiness, i.e. level of risk, capacity to repay the loan. MSME credit risk assessment may be both complex and expensive, when compared to the value of the loan, especially in the case of micro and small enterprises whose data, where available, may not always be adequate or reliable.

132. In order to minimize information asymmetry, the G20 and OECD have recommended⁵⁶ (a) developing information infrastructures for credit risk assessment that support an accurate evaluation of the risk in financing small businesses; (b) standardizing credit risk information and making it accessible to relevant market participants and policymakers, to the extent possible and appropriate; and (c) making credit risk information accessible at the international level so as to foster small businesses' cross-border activities and participation in global value chains. In some countries, the legal and regulatory framework has created information-sharing mechanisms consisting of multiple and complementary sources through which financiers can gather information on a potential borrower before extending credit. This ensures that financiers can properly assess the MSME's creditworthiness and any potential credit risk. The tools presented in the following paragraphs are examples of how information asymmetry can be reduced.

(a) Credit reporting

133. Credit reporting systems play a key role in addressing information asymmetry as they enable the collection and distribution of financial information on potential borrowers thus allowing financiers to evaluate the MSME characteristics, past behaviour, repayment history and current debt exposure. This can help reduce the cost for financiers to conduct due diligence and result in lower interest rates for MSMEs. However, credit reporting may be less relevant in assessing the creditworthiness of the MSME in the context of relationship lending where interactions between the financier and the MSME over time allows the former to collect the information necessary to assess the creditworthiness of the latter. In such a case, credit reporting may play a supplementary role to fill any residual gaps rather than being the primary source of information.

134. Credit reporting providers can be either public entities or privately owned companies: the latter tend to cater to the information requirements of financiers, while the data collected and provided by the former are geared towards use by policymakers, regulators, and other public authorities and entities. In both cases, the service is often provided in a similar way and may raise similar procedural, technological and legal issues in relation to the collection and processing of data, their quality and the access to information by users as well as the data subjects (i.e. the individuals or commercial entities to which the data refer). In recent years, some private credit reporting providers also offer additional services such as building credit risk databases. Credit risk databases collect anonymous information focusing on data regarding borrowers' present ongoing business rather than their past loan performance. They share

⁵⁶ G20 and OECD, High Level Principles on SME Financing, 2015, p. 6.

information on the creditworthiness of the average borrower in the group having the same attributes and enable the building of statistical models.

135. The International Committee on Credit Reporting (ICCR)⁵⁷ has noted the absence in many countries of specific laws addressing commercial credit reporting.⁵⁸ In certain cases, some provisions of the legal regimes for consumer credit reporting may fill that gap. However, not all such provisions may be applicable to commercial credit reporting given the different context. For example, information needed to assess the risk of commercial transactions generally includes significantly more data concerning payment and financial performance than that which is required for individual consumers. Furthermore, protection of data subjects' privacy may be less relevant in the case of commercial credit information, and the underlying provisions may not be relevant to MSMEs.

136. There are, however, certain legal and regulatory aspects that concern the general operation of a credit reporting system or facilitate gathering and sharing information that are important for MSMEs' credit reporting. They include, for example, (a) reporting obligations; (b) access to credit reporting services; and (c) data quality. As noted earlier, women entrepreneurs often face more obstacles than men to build their credit history. In some countries they may lack formal identification documents⁵⁹ (as requirements to obtain such documents may be more burdensome for women than for men) or they may not have an account with a formal financial institution or hold a credit card (see also para. 23), which may prevent them from being considered by the credit reporting providers. An effective credit reporting system for MSMEs would profit from a legal and regulatory framework that remove those obstacles and support women to build their credit history.

(i) *Reporting obligations*

137. There seem to be no standard requirements across jurisdictions for MSMEs to submit financial information to public agencies or other entities. Whereas in many countries there are no reporting obligations, in others the information required is often not sufficient for a robust assessment of the business creditworthiness. While reducing administrative burdens associated with reporting may ease the formation and initial growth of MSMEs, it does not facilitate credit reporting and thus access to credit. In addition, absence of mandatory reporting obligations may prevent small businesses from engaging in good financial reporting practices, which would otherwise be in their interest as a means to demonstrate their sense of accountability and transparency of their operations, thus helping them attract investments as they further progress. Moreover, when MSMEs do not have financial reporting obligations, their creditors may not be willing to share detailed credit performance information about them, since that information may include underlying financial data that may be considered sensitive. As noted earlier, recognizing that publicly available information (e.g. on working capital or capital needs) may help strengthen market reputation, both the UNCITRAL LLE Guide and the UNCITRAL Business Registry Guide (see paras. 64 and 70) advise States to encourage small businesses' voluntary submission of financial information to the relevant authorities.

138. A domestic legal framework that addresses transparency requirements and specifies which type of business information and data should be considered confidential and not subject to reporting obligations would encourage and greatly facilitate MSMEs' financial reporting. Many MSMEs are in fact concerned that disclosing financial and other business-related data may hinder their ability to compete in the market, since it would allow competitors to access sensitive

⁵⁷ The International Committee on Credit Reporting (ICCR) was established in 2009 and is a permanent structure of the World Bank with the goal to set international standards and issue guidelines on credit reporting.

⁵⁸ ICCR, World Bank, *Facilitating SME financing through improved credit reporting*, 2014, p. 20. 19.

⁵⁹ The United Nations has recognized the importance of identification to promote social and economic development, including access to credit, in SDG 16.9 that calls for *legal identity* for all people, including birth registration, by 2030. See <https://sdgs.un.org/goals>.

information. To ensure equal consideration given to the needs of creditors, it would also be important for the legal framework to balance the right of MSMEs to protect their know-how with that of their creditors to collect, analyse and distribute credit-related data.

(ii) *Access to credit reporting services*

139. Public and private credit reporting providers serve different beneficiaries. Therefore, different rules may govern access to their services. Credit risk databases are often maintained by associations formed by financial institutions, credit guarantee corporations and other parties with similar interests, and access to their services may be limited to members.

140. In general, MSMEs should be allowed to access their own data in order to correct or update it as necessary. Moreover, as noted by the World Bank,⁶⁰ the legal and regulatory framework supporting credit reporting should provide that data access responds to impartial rules so that all users of either private or public services have access to information under the same conditions established for that type of service (e.g. access fees or access to the same information). There may be exceptions to this principle of non-discrimination depending on the objective of a particular credit reporting provider. For example, those public credit reporting providers mainly created to support banking supervision and improve the availability and quality of credit data for supervised intermediaries may serve regulated financial institutions only.

(iii) *Data quality*

141. High data quality is the cornerstone of an effective credit reporting system. Data quality is considered high when relevant, accurate, timely and sufficient data, both negative and positive, are collected on a systematic basis from reliable, appropriate and available sources, and are retained for a sufficient length of time. Inaccurate data can result in unjustified loan denials, higher borrowing costs, and other unwanted consequences for MSMEs, data providers (including banks, financial institutions or commercial companies) and credit reporting providers. The accuracy of data depends on how they are gathered, usually through loans and contracts (see para. 144), and how credit reporting providers process the raw data received in order to convert them into the final products that will be accessed by the financiers.

142. High quality data may be achieved by means of a legal and regulatory framework that specifies the purposes for which data may be collected, the circumstances in which they can be used, the required quality and accuracy, the timeliness as well as any limits concerning potential grounds for discrimination (e.g. race, gender, language) and any time limits during which the data may be maintained. For effectiveness of the credit reporting system, these requirements should be applicable to both data and credit reporting providers.

143. Accuracy and reliability of the information provided by the MSMEs when interacting with data providers contributes to data quality. MSMEs should thus be allowed to dispute the accuracy and completeness of their own data and have those complaints investigated and any errors corrected.

(b) Complementary sources of relevant information⁶¹

144. The most common sources of data on MSMEs' creditworthiness are banks and other non-bank financial institutions that are small businesses' most common creditors. Other potential sources of data and information can include commercial entities such as factoring and leasing companies and trade creditors.

⁶⁰ World Bank, *General Principles for Credit Reporting*, 2011, p. 42.

⁶¹ Since "Alternative data" (paras. 147 and 148) are also a complementary source of information on MSMEs' creditworthiness, the Commission may wish to consider revising this subheading along the lines of "Integrating available information" for improved clarity.

145. In order to offset the scarce or inadequate information from all those sources, public sector agencies, such as those mandated by law to receive, store and make accessible to the public certain business information may represent an additional and valuable source of information. Among others, they may provide official identification data for MSMEs, data that contribute to determining MSME's behaviour (insolvency information, for example) and financial information. Security rights registries or registries fulfilling a similar function may provide information on the registration of notice of a possible existence of a security right on assets that MSMEs may use to secure a loan.

146. However, allowing access to information maintained by public agencies requires striking a balance between facilitating the assessment of MSMEs' creditworthiness and protecting sensitive or confidential data relating to the MSMEs, the disclosure of which may require the MSMEs' consent to prevent infringement of their privacy or other rights. In this respect, good practices would call for laws or regulations that clarify (a) if and which data public agencies can share and under which conditions; (b) whether financial institutions or credit reporting service providers can reuse accessible data, if any, for commercial purposes; and (c) specific provisions for the protection of the MSME privacy.

(c) Alternative data

147. When MSMEs or their clients use cloud-based services, communicate with their mobile or smartphones, engage in social media, sell or buy on electronic commerce platforms, ship packages, make e-payments, conclude an online transaction or manage their receivables, payables, and record-keeping online, they create so called "digital footprints", that is traceable information on their browsing and communication behaviour. In recent years, such footprints (also called "alternative data")⁶² have gained increased relevance in credit reporting. The proliferation of alternative data can facilitate access to credit, especially for those small businesses operating in the informal economy that have no or "very thin credit files." Alternative data can also prove beneficial for financiers as it allows a comprehensive assessment of the business's creditworthiness that is not only linked to conventional information such as financial data but also to data created outside the financial system and may thus result in an improved credit score for the business.

148. However, in many countries the absence of an adequate legal and regulatory framework to protect the rights of persons generating such alternative data may lead to inappropriate use of such data in the form, for example, of data inaccuracies, violation of privacy or unauthorized collection or use of personal data and infringement of intellectual property rights. For example, social media data is often collected without the MSME's consent which may result in their inappropriate use since that data is usually not meant to be used for credit reporting purposes. In addition, if collection is not properly monitored, alternative data may lead to discriminatory credit scoring practices based on the race, colour, sex, marital status or other similar attributes of the MSME's owner. With a view to supporting an effective and transparent use of alternative data, international expert forums⁶³ advocate domestic law reforms to clarify how to collect and process such data in a way that preserve their accuracy and integrity (in line with privacy and data protection

⁶² The Global Partnership for Financial Inclusion (GPFI) defines as "alternative" the data generated by the increasing use of digital tools and information systems. See GPFI, *Use of Alternative Data to Enhance Credit Reporting to Enable Access to Digital Financial Services by Individuals and SMEs operating in the Informal Economy*, Guidance Note prepared by the International Committee on Credit Reporting, 2018, p. 14. GPFI is a forum for all G20 countries, interested non-G20 countries and other relevant stakeholders to carry forward work on financial inclusion, including implementation of the G20 Financial Inclusion Action Plan, endorsed at the G20 Summit in Seoul on 10 December 2010. For more information see www.gpfi.org.

⁶³ The Global Partnership for Financial Inclusion (GPFI), *Use of Alternative Data to Enhance Credit Reporting* (supra, footnote 63), p. 6.

international standards), ensure their compliance with credit laws or regulations, and avoid potential discrimination.

Recommendation 8:

To enable financiers to more accurately assess the creditworthiness of potential MSME borrowers, the law should:

- (a) Establish a legal and regulatory framework for the creation and operation of public or private commercial credit reporting systems; and
- (b) Specify the nature and scope of reporting obligations with respect to such systems.

6. Dispute resolution

149. Disputes may arise between MSMEs and financiers on various aspects of their transaction such as excessive fees or interests, use of specific products (e.g. credit cards, leasing etc.), rejections of loan requests or poor financial advice. Concerns that it may be difficult to reach an amicable solution and that the parties will have to engage in lengthy, costly and complex procedures, usually more expensive than the loan value, might discourage MSMEs and financiers from entering the transaction.

150. MSMEs may be encouraged to borrow and financial service providers to extend credit to MSMEs if they are given the opportunity to choose from a variety of judicial and non-judicial dispute resolution mechanisms the one that they consider most adequate to their needs and the nature of a potential dispute. While non-judicial mechanisms are often said to solve disputes that might arise between MSMEs and financiers timely and at relatively low cost, judicial proceedings are equally adequate. Indeed, many countries have introduced small claims courts or simplified procedures that utilise informal hearings, simplified rules of evidence and more streamlined rules in general. Rules of procedure developed for small claims typically limit adjournments of hearings to unforeseen and exceptional circumstances, simplify contract enforcement, and allow the parties to represent themselves. Certain countries have limited the use of expert evidence (and permission to adduce such evidence must be obtained in advance) and permitted the court to deal with the claim without a hearing if the parties agree. If a hearing is required, hearings are held informally. In other countries, the simplified procedures allow hearings to be conducted by telephone and videoconferences, and permit claims to be submitted in electronic format. By reducing the number of procedural steps and keeping costs commensurate to the amount in dispute following default by the MSME borrower, small claims courts may enable expeditious loan recovery in relatively few steps, which in turn, may increase financiers' willingness to lend to MSMEs. The simplified procedures of small claims court make them also an accessible dispute resolution method for MSMEs, which may lack the financial means and skills to handle ordinary court proceedings.

(a) Non-judicial mechanisms

151. To solve disputes between MSMEs and financial service providers out of court in an efficient way, in many States, laws or regulations usually provide for two options which are not mutually exclusive: (a) internal procedures for handling complaints implemented by the financial providers; and (b) external redress mechanisms. MSMEs can decide to access either one or both, but would typically seek redress from external mechanisms if they are not satisfied with the result of the internal complaints handling procedure. Best practices in the operation of both systems should ensure that they are accessible at a reasonable cost, independent, fair, accountable, timely and efficient and do not impose unnecessary burdens on the MSMEs. It should be noted that while internal complaints handling procedures are available to medium-sized enterprises as well, certain external redress mechanisms may be available to micro and small enterprises only (see para. 154).

(i) *Internal complaints handling*

152. Good practices for internal complaints handling mechanisms would call for minimum standards of internal complaints handling procedures across financial service providers offering similar services (including banks and other financiers) set at a level that is not too burdensome for smaller providers to comply with, but nevertheless offers adequate protection to the MSME. At the minimum, the standards should require clear information on the grounds MSMEs can submit a complaint and through which channels. Best practice would also encourage financial providers with sufficient resources to make available specially tailored channels for entrepreneurs with specific needs, such as illiterate ones or entrepreneurs who speak only local dialects. Efficient internal complaint procedures would also require that the financial service providers acknowledge receipt of the complaint without undue delay and that they inform the MSME about the maximum period within which they will give a final response, which should not be longer than the maximum period applicable to an external redress mechanism. Finally, if external redress mechanisms exist, throughout their complaints-handling process MSMEs should be informed about the possibility to seek redress also through such schemes.

(ii) *External redress mechanisms*

153. As noted above, although recourse to internal complaint handling procedures is not mandatory, MSMEs may first try to settle their dispute through those internal means before accessing external redress mechanisms such as financial ombudsman, commercial mediation and arbitration. These mechanisms are not mutually exclusive as they have different scope, and, in some countries, more than one mechanism can address customers' complaints.

154. A financial ombudsman not only investigates and resolves disputes between financiers and MSMEs (though its decisions are often not binding on the parties), but can also provide business support to prevent disputes through initiatives ranging from regular communications to advisory groups or ad hoc meetings. In many countries the ombudsman serves both individual consumers and micro and small enterprises, since they usually face the same challenges and require the same protection in their disputes with banks and other financial intermediaries. In order to determine the eligibility of a business to access the financial ombudsman services, States typically use criteria such as the number of employees or annual turnover that are set at a level which de facto excludes medium-sized enterprises.

155. When the financier and MSME wish to minimize conflict, mediation is an appropriate mechanism to help them preserve their relationship. Mediation is a consensual, informal and flexible process, quicker than litigation and gives parties the chance to understand each other's point of view and to craft tailor-made solutions. As a neutral third party, the mediator will facilitate a dialogue between the MSME and the financier in order to settle the dispute so that the needs and interests of both parties are met. Given its role, the mediator has no authority to impose a binding decision on the parties. The *UNCITRAL Model Law on International Commercial Mediation and International Settlement Agreements Resulting from Mediation* (2018) provides internationally harmonized rules, also applicable in the context of disputes between financiers and MSMEs, to assist States in reforming and modernizing their laws on mediation. In several countries, there are ad hoc banking mediation services that can either offer specific services for small businesses or that are open to businesses of all sizes, including MSMEs, and legal form. Banking mediation may be particularly suitable for small businesses: not only does it foster amicable settlement of disputes with financiers, but it also facilitates mutual exchange of financial information and strengthens MSMEs' capacity to supply adequate information in a financial transaction. As it has been noted,⁶⁴ the benefits of banking mediation often extend beyond an individual loan case. Financiers and MSMEs may be encouraged to

⁶⁴ OECD (authored by L. Cusmano), *Credit mediation for SMEs*, 2013, p. 29.

have prior recourse to mediation and banking mediation (where it is in place) before considering adversarial dispute resolution options such as arbitration.

156. If the dispute cannot be resolved amicably and requires formal resolution, expedited arbitration may be a preferable alternative to litigation, particularly for small loan disputes since it is a simplified, time-effective and cost-efficient procedure. Although arbitration follows procedural rules adaptable to the needs of the parties and provides flexibility for scheduling and venue of the hearings, it is an adversarial proceeding and it requires legal counsel and sometimes other experts. Depending on the amount of the dispute, it may be an expensive and unattractive option for an MSME. On the other hand, arbitral awards are final and are only subject to annulment by court decision in narrowly defined circumstances. UNCITRAL legislative and contractual texts on international commercial arbitration⁶⁵ provide a comprehensive set of rules to assist States also develop and strengthen the domestic arbitration regime, and inspire arbitral institutions in drafting rules for arbitration proceedings.

(b) Online dispute resolution

157. To increase MSMEs' access to dispute resolution, both States and regional organizations are increasingly supporting the use of online dispute resolution which can apply to both internal complaints handling procedures and external redress mechanisms. Online dispute resolution (ODR) mechanisms are easy-to-use, fast and low-cost platforms and do not require the physical appearance of the parties. These and other features make them particularly suitable for low value disputes and disputes arising out of cross-border transactions. For example, the Asia Pacific Economic Cooperation (APEC) has launched the Collaborative Framework for Online Dispute Resolution of Cross-Border Business to Business Disputes⁶⁶ for the purpose of helping small businesses resolve cross-border low value disputes. Online dispute resolution mechanisms require a conducive legal environment that permits, for example, choice of forum and does not require physical appearance of the parties or physical written submission of documents. States may thus have to amend domestic laws accordingly. The *UNCITRAL Technical Notes on Online Dispute Resolution* (2017)⁶⁷ may provide guidance to States, ODR platforms and administrators regarding how to develop and use such mechanisms.

7. Enforcement

158. The next step after a court or arbitral tribunal has established the obligor's default will be the enforcement of the decision by creditor to recover the outstanding sums. Timely, predictable and affordable enforcement is important for both secured and unsecured obligations. In case of secured obligation, creditors usually obtain satisfaction from the proceeds of the sale of the assets of the obligor. Some legal systems may also allow a creditor to proceed to execution against a defaulting obligor without having to first obtain a judicial decision on the merit. A wide variety of approaches for extra-judicial enforcement exist in different jurisdictions.

159. Section 2 above (on secured transactions) highlights the importance of effective enforcement for a secured transaction regime that facilitates credit for MSMEs in respect of both movable and immovable assets (see paras. 80 and 90). Elaborate enforcement procedures may have a negative impact on access to credit for MSMEs. For example, the financier may be required to bring an action before a court or other

⁶⁵ The UNCITRAL texts relevant in the context of the Guide include the *UNCITRAL Model Law on International Commercial Arbitration* (1985), with amendments adopted in 2006; *UNCITRAL Expedited Arbitration Rules* (2021); and *UNCITRAL Arbitration Rules* (2010) with article 1, paragraph 4, as adopted in 2013 and article 1, paragraph 5, as adopted in 2021.

⁶⁶ APEC Collaborative Framework for Online Dispute Resolution of Cross-Border Business-to-Business Disputes – Endorsed, 2019/SOM3/EC/022. Available at www.apec.org/SELI/Overviewin.

⁶⁷ The *UNCITRAL Technical Notes on Online Dispute Resolution* (2017) are available in all official languages of the United Nations at <https://uncitral.un.org> – section “Texts and Status – Online dispute resolution”.

authority in order to have its security right recognized and to seize and sell the collateral under strict rules and the supervision of a public official.⁶⁸ Availability of effective and cost-efficient enforcement mechanisms, including out-of-court enforcement (as provided in the *Model Law*) is likely to encourage financiers to lend based on MSMEs' assets. The *Model Law* imposes conditions on how financiers can undertake out of court enforcement in order to minimize any risks of misuse (arts. 77 to 80).⁶⁹ The possibility of out-of-court enforcement under the *Model Law* is intended to expedite foreclosure and thus reduce lending costs. It does not preclude a debtor's access to court where enforcement action by the creditor is not in accordance with the law.

160. It should be noted that laws other than the secured transaction law could impact a financier's enforcement options in respect of secured obligations. For example, certain laws may restrict the creation of security rights in household goods, or limit the seizure of personal assets, or the amount for which a security right in those assets can be enforced. Whether certain categories of assets, such as essential personal assets or household goods, should be exempt from enforcement is a policy question for each State. The *Model Law* does not override these provisions (art. 1(6)). Financiers can deal with such exemptions as long as they are set out in a transparent way in the law.

8. Support for MSMEs in financial distress

161. An effective and efficient insolvency regime facilitates access to credit not only through reorganization⁷⁰ and supporting pre-commencement out-of-court debt restructuring options, but also by ensuring reallocation of resources for productive uses through appropriate business viability verification mechanisms and speedy liquidation of non-viable businesses.

162. Debt restructuring options provided in an effective and efficient insolvency regime are key to any support to MSMEs in financial distress. However, even though the use of technology (such as artificial intelligence and big data) may potentially reduce restructuring costs, MSMEs facing financial difficulties are unlikely to have the resources to face restructuring costs, including the cost of seeking professional advice. Many viable small enterprises are thus being forced into insolvency because adequate restructuring options are not available at an early stage of their financial difficulties. An efficient restructuring framework may not only help preserve otherwise viable MSMEs, but also avoid the nearly inevitable loss and cost incurred by financiers filing claims in liquidation proceedings, thereby maximizing value for creditors, owners and the economy as a whole. Furthermore, such framework might also contribute to the efficient management of defaulting loans and to avoid the accumulation of such loans on banks' balance sheets, which limits a bank's capacity to offer loans to MSMEs. Not all financing made available to an MSME as part of a pre-commencement restructuring regime will be beneficial in assuring the long-term viability of the enterprise. In assessing whether pre-commencement financing will be beneficial, the MSME should consider the terms of any proposed pre-commencement financial transactions so as to assess whether they would restrict the MSME from effectuating a reorganization if an insolvency proceeding became necessary (see para. 164). Examples of pre-commencement transactions that might, in some circumstances, impede a successful reorganization include transactions in which the pre-commencement financier is granted a security interest (or similar lien) on all the assets of the MSME, or those in which the financier requires a transfer of those assets to the financier for lease back to the MSME.

⁶⁸ *UNCITRAL Legislative Guide on Secured Transactions*, Chapter VIII, para. 1.

⁶⁹ *UNCITRAL Practice Guide* (supra, footnote 29), para. 304.

⁷⁰ The term "reorganization" refers to the process by which the financial well-being and viability of a debtor's business can be restored and the business continue to operate, using various means possibly including debt forgiveness, debt rescheduling, debt-equity conversions and sale of the business (or parts of it) as a going concern.

Mechanisms under insolvency law

163. Although not specifically tailored to the needs of MSMEs, parts one and two of the *UNCITRAL Legislative Guide on Insolvency Law* (2004)⁷¹ offer useful guidance for building a support system for MSMEs' access to credit. For example, financiers may be more willing to lend when there are transparent and certain rules on (a) the treatment of claims and recognition of their rights and claims arising under law other than the insolvency law, such as secured transactions law;⁷² (b) treatment of contracts under which both the debtor and its counterparty have not yet fully performed their respective obligations;⁷³ and (c) the exercise of set-off rights existing under the law other than the insolvency law.⁷⁴ Moreover, financiers may be further incentivised to lend after the commencement of insolvency proceedings when rules establish priority for new finance provided after the commencement of insolvency proceedings (at least ahead of ordinary unsecured creditors) and allow granting a security right on both unencumbered assets and already encumbered assets.⁷⁵ Finally, an expedited procedure for court confirmation of a restructuring plan negotiated between the debtor and creditors may also encourage creditors to participate in such negotiations.⁷⁶

164. The *UNCITRAL Legislative Guide on Insolvency Law for Micro- and Small Enterprises* (the “*Legislative Guide*”) is designed to address the unique circumstances of micro and small enterprises.⁷⁷ Provisions concerning new financing, informal restructuring and early rescue mechanisms are particularly relevant in this context. The *Legislative Guide* recommends facilitating and providing incentives for new finance to be obtained by those micro and small enterprises in financial distress before commencement of insolvency proceedings for the purpose of rescuing businesses and avoiding insolvency. Such incentives should include appropriate protection for the providers of such finance (including the payment of the finance providers at least ahead of ordinary unsecured creditors) and for those parties whose rights may be affected by the provision of such finance.⁷⁸

165. The *Legislative Guide* also recognizes the importance of informal debt restructuring negotiations. States are encouraged to provide appropriate incentives for the participation of creditors in informal debt restructuring negotiations (in the form, for example of tax incentives, exempt transactions arising from informal debt restructuring negotiations from avoidance proceedings).⁷⁹ They are also encouraged to identify and remove disincentives for the use of informal debt restructuring negotiations, as may result, for example from provisions that create an obligation to file for formal insolvency within a certain period after the occurrence of certain events or insolvency law provisions on avoidance of transactions concluded during a certain period before filing for insolvency.⁸⁰ Furthermore, institutional support with the use of informal debt restructuring negotiations, such as the involvement of a competent public or private body to facilitate negotiations, is also recommended.⁸¹

166. Further, the *Legislative Guide* envisages establishing mechanisms for providing early signals of financial distress to micro and small enterprises, increasing financial

⁷¹ The *Legislative Guide* is available in the six official United Nations languages at <https://uncitral.un.org/> – section “Texts and Status – Insolvency.”

⁷² *UNCITRAL Legislative Guide on Insolvency Law* (2004), recommendations 3, 4 and 188.

⁷³ *Ibid.*, recommendations 69–86.

⁷⁴ *Ibid.*, recommendation 100.

⁷⁵ *Ibid.*, recommendations 63–68.

⁷⁶ *Ibid.*, recommendations 160–168.

⁷⁷ *UNCITRAL Legislative Guide on Insolvency Law for Micro- and Small Enterprises* (2021). It is also published as part five of the *UNCITRAL Legislative Guide on Insolvency Law* and is intended not to replace but to supplement the guidance given in other parts of the *UNCITRAL Legislative Guide on Insolvency Law*. The *UNCITRAL Legislative Guide on Insolvency Law for Micro- and Small Enterprises* is available in the six official United Nations languages at <https://uncitral.un.org/> – section “Texts and Status – Insolvency.”

⁷⁸ *Ibid.*, recommendation 107.

⁷⁹ *Ibid.*, recommendation 105 and related commentary.

⁸⁰ *Ibid.*, recommendation 104 and related commentary.

⁸¹ *Ibid.*, recommendation 106 and related commentary.

and business management literacy among micro and small enterprises' managers and owners and promoting their access to professional advice.⁸² The *Legislative Guide* highlights three mechanisms that may be of particular assistance to ensure early rescue of such small businesses. First, early warning tools may be put in place by the State or private entities to detect circumstances that may trigger insolvency and could signal to the businesses the need to act without delay. Second, educational tools should be made available to micro and small enterprises to improve their financial and business management literacy and skills (see also para. 178). Lastly, micro and small enterprises' access to professional advice on debt restructuring options or matters relating to insolvency commencement, which may be provided by public or private organizations, should be promoted.⁸³

Recommendation 9:

In order to address MSMEs' financial needs in the context of insolvency, the law should reflect existing international standards such as the *UNCITRAL Legislative Guide on Insolvency Law* and the *Legislative Guide on Insolvency Law for Micro- and Small Enterprises*.

9. Transparency and other fair lending practices

167. Fair contract terms and business practices are the foundation of trust in commercial relations. Parties in equal bargaining positions typically arrive at mutually satisfactory agreements, but weaker parties, as may be the case of MSMEs dealing with financial services providers may be exposed to disadvantageous standard contract terms. In many legal systems, the law intervenes to prevent or mitigate the consequences of a party taking undue advantage of the other party's weakness. While it is important for domestic laws to address unfair contractual terms and practices, any rules to that end should strike a balance between protecting the MSME against possible abusive behaviour, on the one hand, and ensuring the enforceability of financing contracts, as an incentive for financiers to lend money to MSME, on the other hands (see also para. 7). Safeguards against abusive practices should serve to protect legitimate expectations of an MSME but should not provide a pretext for them to avoid repaying their debts or repudiating their obligations. The appropriate balance will be a matter of policy and will often depend on the state of a country's domestic lending market.

(a) Transparency

168. MSMEs typically lack the resources or knowledge to conduct thorough market analysis and comparison of credit terms. Transparent information by financiers to potential MSME borrowers is therefore essential for MSME access to credit. Transparency makes it easier for MSMEs to find the most suitable products in terms of quality and costs, and to make informed choices. This helps reduce the cost of credit and at the same time strengthens the mutual understanding of the parties which can facilitate lending-related decisions. Two dimensions of transparency are particularly relevant: clear and transparent terms and conditions for credit products and services; and availability of sufficient information for MSMEs on different means to access credit (see paras. 178 and 181).

169. In most jurisdictions, the rules on the transparency of contractual terms and fair relations with customers generally apply to various standard banking and financial products and services (e.g. current accounts, deposits, loans and payment services). For example, financiers may be required to disclose the information in a prescribed form including standardized methods of displaying charges. Disclosure should highlight key features of the credit, such as access conditions, risks for the borrower, restrictions, to induce MSMEs to pay attention to them. Transparency on the price of financial services, the calculation of financial charges or the risk of investment

⁸² Ibid., recommendation 103.

⁸³ Ibid., recommendation 103 and related commentary.

products is particularly important to avoid situations where the true cost of loans is obscured (for instance because the MSME clients do not realize the effective interest rate over the life of a loan contracted under a “flat” rate, or because of a complex fee structure). Among other things, international experts’ forums⁸⁴ recommend that MSME lenders, including microfinance institutions, should be required to adopt standard pricing formulas (with appropriate disclosure standards) as well as standard repayment schedules. Such clarity permits MSMEs to make informed decisions and ensures them a certain degree of protection against irresponsible lending practices that could lead to MSME over-indebtedness, while minimizing the risks of MSME’s misuse of loans. At the same time, clarity of contractual terms and conditions benefits financiers too as it increases their credibility on the market thus encouraging MSMEs to enter into financial transactions.

170. Transparency and disclosure of information are of great importance also in transactions between MSMEs and non-bank institutions given that in certain countries digital financial service providers that are not regulated (e.g. FinTech companies) may not be required to disclose specific product terms, such as the loan terms, which may be incomplete or unclear; annual percentage rate; or transaction fees, which may result in MSMEs unknowingly paying higher fees than expected. International experts’ forums thus recommend that States also require non-bank institutions to disclose information in a way that is clear and understandable to small businesses that may not often have adequate financial literacy.⁸⁵ It would be equally important that digital financial service providers disclose information on the technology used to support the operation of online platforms and in particular any significant change in hardware or software components that may negatively affect the MSME’s ability to access its records or perform digital operations.

Recommendation 10:

To help ensure that MSMEs are aware of their rights and obligations, the law should provide that terms and conditions of the credit agreement are presented by financiers to MSMEs in a clear, legible and understandable way.

(b) Other fair lending practices

(i) Contract formation

171. In some countries, fair treatment of MSMEs would require that in the process of contract formation the financier explains the different types of credit suitable to the MSME and their implications for the business, and clarifies the meaning of the contract terms, in particular technical terms and financial terms, such as those concerning interest rates, in a way that they are understandable and comparable to the terms used by other financiers. To ensure that MSMEs can appreciate all potential unfavourable conditions, small print clauses are sometimes subject to an ad hoc agreement by the borrower MSME. In addition, in some countries financiers allow for a reflection period before the conclusion of the contract or a period for exercising a right of withdrawal after the conclusion of the contract or a combination of the two to ensure that the small business has fully understood the contract terms and assessed the consequences of their application. In case the MSME’s credit application is rejected, applicable laws or regulations may require financiers to provide the reasons for rejection in a clear and understandable way.

(ii) Contract terms

172. Given their limited financial literacy, many MSMEs may not be able to identify or fully understand the potential unfavourable contractual conditions and may be expose to abuse by financiers who take advantage of their stronger bargaining position. In order to tackle unfair contract practices, some countries have extended to MSMEs

⁸⁴ Global Partnership for Financial Inclusion (GPFI), Promoting digital and innovative SME financing, 2020, p. 72.

⁸⁵ Ibidem.

domestic legislation that protects weaker individuals negotiating contracts with parties who enjoy a stronger bargaining position, including financial transactions. Such legislation may specify what a small business is and clarify the parameters according to which a contract term can be deemed unfair, such as excessive default interest rates, unfair termination clauses or grossly disadvantageous definitions of events of default. In other countries, the goal of ensuring fair contract terms and conditions has been achieved through policy measures enacted by central banks, or voluntary codes of conduct or practice standards in the financial industry sector set the benchmark for fair lending practices. Although such tools might be more rigid than certain regulatory or legal standards and afford high levels of protection to small businesses, they cannot be an alternative to appropriate and enforceable laws that set out the obligations of the financiers.

173. The World Bank has compiled good practices for financial consumer protection which may apply to microentrepreneurs and small enterprises as they often face the same consumer protection issues as individuals.⁸⁶ Those good practices suggest that the law should prohibit unfair terms or conditions in standard financial contracts and, if used, such terms or conditions would be considered void and legally unenforceable. In addition, any ambiguity in a standard contract should be construed against the interests of the party that proposed the ambiguous term, thus leading to an interpretation more favourable to the MSME, as the weaker party to the contract. In this regard, the fairness of a contract term, especially when such term is a non-financial one, would not be assessed in isolation but in the context of the other terms of the contract. In specifying types of clauses that the law declares unfair and therefore invalid or not effective, legislators and policymakers may wish to consider the possible impact that an overly restrictive approach might have on the availability of credit. Finally, States might also protect small businesses by establishing legislative caps on certain rates and charges imposed in the contract: for example, in certain countries the applicable laws or regulations establish caps on default rate clauses.

Recommendation 11:

The law should identify both the formalities and content requirements necessary to make a credit agreement effective.

10. Electronic environment

174. A legislative framework supportive of platform-based crowdfunding consists mainly of regulatory measures or laws that do not fall under what may be regarded as general commercial law. For example, data protection laws address the duty of the platform to protect data of its users; general banking laws deal with “know your customers” obligations; and laws on anti-money-laundering and countering the financing of terrorism may apply to platform’s operators. Commercial or contract laws that are relevant in this context primarily include laws that ensure the formation, validity and enforcement of contracts concluded through electronic means. In this respect, UNCITRAL legislative texts on electronic transactions, digital identity and trust services⁸⁷ can provide solutions appropriate to different legal traditions and countries at different levels of economic development.

175. For example, the *UNCITRAL Model Law on Electronic Commerce* (1996) (MLEC) establishes rules for the equal treatment of electronic and paper-based information, as well as the legal recognition of electronic transactions and processes, based on the fundamental principles of non-discrimination against the use of electronic means, functional equivalence of electronic and paper-based records, and

⁸⁶ World Bank, *Good Practices for Financial Consumer Protection*, 2017.

⁸⁷ All UNCITRAL texts facilitating the use of electronic means to engage in commercial activities are available in the six official languages of the United Nations at <https://uncitral.un.org/> – section “Texts and Status – Electronic Commerce”.

technology neutrality.⁸⁸ The *UNCITRAL Model Law on Electronic Signatures* (2001) (MLES) complements MLEC through establishing criteria of technical reliability for the equivalence between electronic and hand-written signatures. Based on the same principles of MLEC, the MLES also establishes basic rules of conduct that may serve as guidelines for assessing duties and liabilities for the signatory, the relying party and trusted third parties intervening in the signature process. In the context of electronic records, the *UNCITRAL Model Law on Electronic Transferable Records* (2017) (MLETR) aims to enable the legal use of electronic transferable records both domestically and across borders. The MLETR provides that an electronic transferable record satisfying the conditions of the MLETR shall not be denied legal effect, validity or enforceability on the sole ground that it is in electronic form. Furthermore, the *UNCITRAL Model Law on the Use and Cross-border Recognition of Identity Management and Trust Services* (2022) addresses various obstacles to the broader use of identity management and trust services, including across borders.

176. Additional legal clarity may be needed for certain technological developments that support new ways of concluding and managing contracts, mainly through applications using artificial intelligence introduce non-traditional contractual arrangements (for example, smart contracts⁸⁹ or robo-advisors⁹⁰). Such new contracting methods may raise issues of validity, binding nature, enforceability or liability for errors that domestic current laws may not properly address. These issues are being considered by UNCITRAL as part of a new project of its Working Group IV on the topic of automated contracting, which will examine gaps in the current law and possible legal solutions.⁹¹

177. It should be noted that several countries have established legally and regulatory protected environments (colloquially called “regulatory sandboxes”) to test in a time-bound manner and under the control of regulatory authorities’ new products and services developed by FinTechs (including in relation to platform-based crowdfunding) in order to determine whether they can be brought to the mass market. Sandboxes permit regulators to identify any associated risks with these innovations and introduce new laws or regulations, or enhance existing ones, to better address them. Certain countries, for example, have enacted laws to facilitate the establishment of regulatory sandboxes as a key element of their domestic fintech system. Regulatory sandboxes are advantageous for FinTechs too, since they can receive advice from regulators on how to navigate the regulatory environment and obtain authorization for the new products.

C. Other measures to enhance MSME’s access to credit: financial literacy

178. An important practical way of facilitating access to credit for MSMEs is to improve their financial literacy so as to help them understand the various types of financial products available, approach the relevant institutions, make informed and effective decisions with their financial resources and prepare a good loan proposal. Financial education may also need to be provided for MSMEs to fully understand the advantages and the consequences of granting a security right over their assets and the

⁸⁸ The principle of “technological neutrality” means that the law does not presuppose the use of particular types of technology. The principle of “functional equivalence” establishes the criteria under which electronic communications may be considered equivalent to paper-based communications.

⁸⁹ In the context of FinTech transactions, the term “smart contract” may be used to refer to situations in which the contractual obligations of the parties are discharged through the automated performance of the software, once the borrower has agreed to the terms and conditions with one click (“I agree”), and the contracts are unalterable.

⁹⁰ Robo-advisors are online platforms that use algorithms to automatically build and manage clients’ portfolios.

⁹¹ The Commission may wish to consider whether this sentence can be deleted since it will require redrafting after the Guide is adopted and published as work of Working Group IV on automated contracting progresses.

legal requirements of a security agreement (for example, how to create a security right, rights and obligations of the grantor, enforcement). Furthermore, MSMEs may need a wider set of skills to operate proficiently within their business environment and to improve their ability to comply with business and financial information disclosure requirements or other information expectations from financial market participants. For example, businesses in the initial stages of their lifecycle may need to know how to identify markets, introduce appropriate costing methodologies, enhance their accounting practices or comply with government regulations. More established businesses may need to improve their internal organization or the quality of processes and products (e.g. from the introduction of regular maintenance of their equipment to the adoption of quality certification schemes for their products or manufacturing processes) or their skills in marketing and exporting and to be fully aware of International Financial Reporting Standards and the benefits they can bring in terms of access to credit. Financial education may thus be complemented by programmes aiming at strengthening the managerial and technical skills of MSMEs. Finally, in countries with external redress mechanisms for financial disputes (see paras. 153 to 156), MSMEs are often unaware that they can resolve their disputes with financiers through those channels. MSMEs eligible to use redress mechanisms could thus benefit from training on their scope and functioning (e.g. claim submission and handling, decision-making process), which may also be an additional incentive to access financial services.

179. Not only financial literacy facilitates MSME access to credit: it is equally important to enhance financiers' capacity to properly assess the financial needs of MSMEs and any particular requirements of lending to such small businesses. They need to know which types of financial products to offer and how to address the difficulties that MSMEs face in approaching financiers, preparing necessary documentation, and meeting relevant criteria. This may apply particularly to financiers catering to women entrepreneurs, many of whom have limited access to information and financial literacy at the outset of entrepreneurial activity. Finally, capacity-building is key to help regulators keep abreast of new laws and regulations applicable to MSMEs' financing in order to assist financial institutions in their implementation and ensure adequate supervision.

1. Capacity-building for MSMEs

180. In several countries, strategies for financial education have been implemented with the expectation that they will encourage entrepreneurship and reduce the demand-side barriers to finance for all sizes and types of MSMEs (i.e. regardless of whether they are natural or legal persons). Those strategies can be either directed at MSMEs only or at MSMEs and citizenry as well. Regardless of the scope of the education strategy, micro and small enterprises are often the most targeted segment within the MSMEs' group. Certain countries pursue MSMEs' financial education as part of broader strategies aiming at promoting financial inclusion or increasing formal sector employment.

181. Effective strategies at country level may be provided through different channels such as formal education in schools or universities or ad hoc government programmes that may be offered in partnership with the private sector or universities (e.g. university MSME centres). The strategies usually cover general elements of financial literacy as well as topics relevant to building the MSME capacity to interact with financiers, such as knowing who to approach for assistance on financial matters; recognizing the interplay of personal and business finances; awareness of financing opportunities, financial risks and how to manage them effectively; and knowing how to meet loan requirements. The long-term sustainability of the strategies requires allocating sufficient funds, but also making available diagnostic tools to assess MSME's literacy needs and adequate monitoring and evaluation of strategy implementation.

182. In addition to government strategies, other initiatives coordinated by industry organizations and trade unions, the financial sector or non-governmental

organizations (NGOs) may be implemented at the local and country level. For example, stock exchanges and capital market institutions can launch programmes to help small and medium-sized enterprises deal with access to long-term financing opportunities. Training and tutorship can help those businesses to improve their skills in order to facilitate a possible listing in the public equity market.

183. Depending on the nature of the financial education initiatives, and in order to reach the widest group of beneficiaries possible, different delivery methods can be used ranging from leaflets to coaching, seminars or advice services, online courses, or other forms of digital delivery, including social media or mobile applications. In certain countries, online platforms have been set up to facilitate exchanges and mutual learning between small businesses. Other countries, recognizing the great challenges faced by women-run MSMEs, have established dedicated online hubs to advance women entrepreneurship, including their access to financial services. More traditional media (e.g. TV, radio and magazines) can be employed to reach out to larger audiences compared to those using social media that may require more advanced technological skills. Depending on the nature of the providing entity, whether the State, NGOs, or the industry sector and the scope of the initiatives, they may be fee-based, or without fees, although it is desirable that given the financial limitations of MSMEs paid-for initiatives be limited. It should be noted that both the government-led strategies and the initiatives coordinated by the private sector often benefit from tools and programmes developed by international organizations or networks that reflect global best practices.

2. Capacity-building for financiers

184. In order to improve the capacity of financiers to respond to MSME's financial needs and understand how to enter into profitable transactions with them, certain countries have addressed the information gap between financiers and small businesses by facilitating their direct interaction through awareness-raising campaigns, brokerage and match-making. More generally, financiers should understand the sectors in which MSMEs operate and how to assess loan applications against the background of those sectors; identify the best customers to serve; carry out market analysis to optimize the products and services offered, including designing new products and services specifically tailored to MSMEs, or particular groups of MSMEs; develop an appropriate sales culture and distribution channels as well as appropriate risk management strategies to sustain solid MSMEs in critical moments of their life cycle.

185. As noted earlier, it is important that financiers receive guidance (through codes of conduct or training) on best lending practices applicable to their transactions with MSMEs so they can manage and mitigate their risks without deteriorating the credit terms for the MSME. For example, financiers should be able to effectively advise MSMEs on the most suitable products given their needs and financial situation, monitor their loans in order to avoid the risk of default and promptly respond with appropriate solutions when MSMEs experience payment difficulties. They should also be prepared to implement legal reforms that introduce new tools for MSME access to credit. For example, if a country adopts a secured transaction law consistent with the *Model Law* (see paras. 74 to 80), financiers should build the capacity to understand the new legal environment and identify and structure transactions involving movable assets as collateral that are made economically feasible by that legal environment. This may include developing their expertise to perform reliable valuations of the assets offered as collateral by MSMEs which provide the basis for making rational predictions as to how much can be realized from the collateral(s) in the event of default. Difficulty to determine the value of the movable assets offered as collateral by an MSME, because their replacement value (from the MSME perspective) may be much higher than the actual market value or the assets may not be regularly traded in a given market, may discourage financiers from extending credit to MSMEs.

186. In some jurisdictions, financial providers are required to adopt certain measures (also known as responsible lending practices) to ensure enhanced protection of non-commercial borrowers as those borrowers might be less familiar than businesses to lending processes. Although some of those practices may result in longer credit processing time, they ensure that financiers act in the best interest of the borrower. Raising financiers' awareness on the application of responsible lending practices also in their transactions with MSMEs might well be another element of financiers' capacity-building.

187. Capacity-building initiatives for financiers may be organized under the aegis of central regulators or the relevant government authorities and include training programmes for those in charge of MSMEs' departments, such as training of trainers, peer-to-peer learning or advisory services. Financial service providers should also develop in-house programmes (e.g. workshops or on-the-job training) to ensure regular improvement of staff expertise and skills.

188. As in the case of financial literacy for MSMEs, international organizations offer support to improve financiers' capacity to serve MSMEs through technical assistance activities ranging from face-to-face or web-based workshops, on-the-job training for branch managers, loan and other officers on all relevant aspects of MSME lending, global advisory programmes for financial institutions, to ad hoc guidance materials. The *UNCITRAL Practice Guide to the Model Law on Secured Transactions* can be cited as an example of such guidance that, among others, well explains to lenders and borrowers, including smaller businesses, how secured transactions can facilitate access to credit at a reasonable cost.

3. Capacity-building for regulators

189. Regulatory and supervisory bodies play a leading role in facilitating access to credit for MSMEs. They must be able to create and maintain a conducive environment for MSME lending, including fostering competition among financial institutions to serve MSMEs and adjusting the regulatory regime in accordance with legal reforms that stimulate access to credit. For example, if a country adopts a secured transactions law consistent with the *Model Law* (see para. 185), regulatory and supervisory bodies need to have the capacity to understand the new legal environment and to assess potential risks associated with transactions involving movable assets so as to determine whether and how to adapt existing regulatory guidelines in light of the changed legal environment and the reductions in risk resulting from it. Further, in the past years an emerging global reform trend has increasingly moved financial institutions away from relationship-lending to transaction-based lending, thus requiring regulators to develop additional technical skills to oversee the conduct of the financial institutions. Finally, the increasing preparation of financial standards in international forums, in order to ensure global financial stability, also calls for regulators' improved knowledge and ability to effectively implement those standards once they are adopted by the State.

190. In order to adequately respond to the multiple demands of the financial sector, regulators must thus have a diverse set of skills and the capacity of keeping abreast of developments. To support regulators, States can thus put in place mechanisms to regularly assess regulators' changing capacity-building needs and tackle any gap with a variety of complementary tools. For example, participation in international forums allows peer-to-peer learning as it facilitates the dissemination of international standards and the exchange of best practices. Preparation of technical guidelines is particularly effective when new financial products enter the market or after the implementation of legal and regulatory reforms. Regulatory sandboxes also provide a valuable protected environment for regulators (see para. 177) where they can learn from new products and credit providers, in particular FinTechs related, and enhance their capacity to adjust the existing regulatory framework to the evolving needs of the financial sector. Workshops and seminars, whether online or in person, permit to improve regulators' knowledge with the assistance of experts and to delve into specific topics in greater depth. Again, international organizations can play a key role

in complementing country specific and regional initiatives. In addition to organizing seminars, conferences, preparing technical guidance and publications, they can facilitate international cooperation among financial regulators and partner with States and regional entities to offer technical assistance and advisory programmes tailored to the needs of a specific country or region.

Recommendation 12:

States should further enhance the legal and policy measures supporting MSME access to credit with relevant programmes and policies for improving the legal and financial literacy of MSMEs and the capacity of financiers and regulators.

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