MICROLOANS AND THE FUNCTION OF COLLATERAL

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Structure of the Presentation

1. The model and practice of securing microloans with collateral

2. Protections of microborrowers
3. Registration of notices relating to microloans
4. Suggestions for future work of UNCITRAL

Increasing Use of Collateral in Microloans

- Traditional group-lending unsecured model vis-à-vis individual secured model

- Typical microloan collateral: household assets, inventory and equipment (vehicles)

- Secured loans are typically, in addition, guaranteed by the borrower

Secured Lending Model

- The secured microloan model differs from the group-guarantee lending model:
  - Ability to earn money is the primary source of repayment
  - Collateral is secondary – provides recourse in case of default
  - Guarantees are tertiary

Assessment of the Business Borrower's Ability to Repay

<u>BORROWER FINANCIAL CONDITION AND CAPACITY</u>

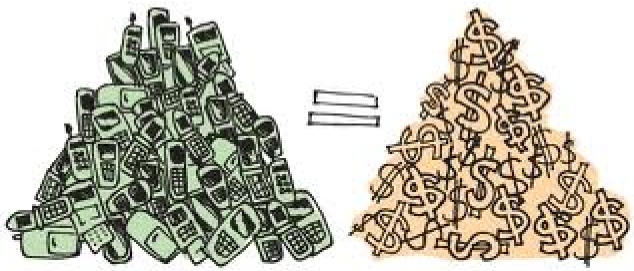
- Cash flow, leverage, and collateral
- Borrower's financial performance compared to peers
- Is the borrower's business seasoned**?**

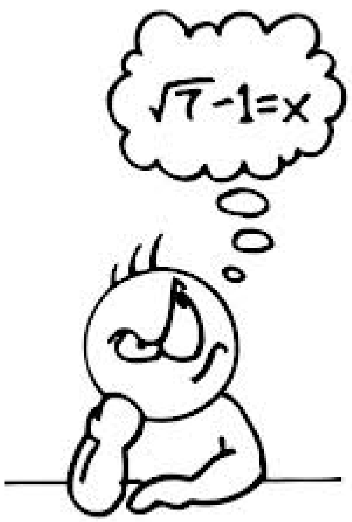
<u>ECONOMIC, INDUSTRY AND REGULATORY ENVIRONMENT</u>

- Is the industry declining, growing or stable?
- Significant regulatory risk**?**
- Are there "barriers to entry"**?**

How Much to Lend Against Collateral?

- The value of collateral determines advance rates





- Difficulty in establishing collateral value particularly those for assets that secure microloans

Valuation of Collateral

- Relatively straightforward: money-like assets such as accounts and bank deposits
- Moderately straightforward: new equipment and vehicles
- Difficult: farm products
- Almost impossible: used household and personal items

Overcollateralization is Common

- 100% or even 120% advances are not prudent
- The risk of deterioration, misappropriation, competing claims and enforcement costs
- Lenders loan a percentage of the collateral value
  e.g., 35% on inventory
  and 80% on accounts

Borrowing Base Sample

A. Total Accounts Receivable:	**1,000**
Less: Balances >90days	< 200>
Less: Concentrations >10% of total Receivables	< 250>
Net Eligible Accounts Receivables:	550
A. Borrowing Potential at 80%:	**440**
B. Total Inventory:	**5,000**
Less: Work in Progress	<1,000>
Less: Trade Accounts Payable:	<1,500>
Net Eligible Inventory:	2,500
B. Borrowing Potential at 35%:	**875**
Advance (A+B):	**1,315**

Is Microlending True Asset-Based Lending?

- Do microlenders make advances against collateral or take collateral because they can?

- True secured lending entails costs, including valuation, monitoring, search and registration fees, etc.

UNCITRAL Legislative Guide

- Objective to allow debtors to use the full value inherent in their assets
- Recommendation 2 – the Law should apply to all types of movable assets and security rights created by all legal and natural persons, including consumers
- Consumer protection statutes remain unaffected
- Many secured microloans do not involve consumers

Protections for Microbusinesses

- Provide for limitations to third-party effectiveness or enforceability

- Protections of exempted assets against creditors and insolvency administrators

- Typical limitations and exemptions include a list of assets and monetary values

Protected Assets

- **Limited Enforceability:**
  - Percentage of income may not be attached
  - A specified sum deposited to a bank account

- **Exemptions:**
  - "Household goods" that include clothing, musical instruments, children toys, medicine
  - "Tools of trade" that include books of the business, equipment up to a certain value



Registration and Transparency under the UNCITRAL Legislative Guide

- The Guide's objective is to enhance transparency by registration
- Mandates reasonable and flat registry fees
- Minimal required information reduces cost
- The inability to search by the secured creditor's identifier protects privacy

Registration and Transparency for Microloans

- Reduced or no registry fees for microloans that do not exceed a certain amount

- Failure to register = ineffectiveness and loss of priority
- Should registrations indicate an interest rate?
- Should searches by the secured creditor's name be allowed to promote competition?

Considerations for Future Work

Practice-oriented consideration:

- Asset-based lending involves advances against the collateral value (overcollateralization is common)

Legal consideration:

- Protection of defined categories of assets by limiting enforcement and providing exemptions

Registry consideration:

- Modifications to the registry system, including fees and search capabilities

THANK YOU!

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