

# Price Transparency & Truth-in-Lending

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# Disclaimer

The views expressed in this presentation are solely my own and do not represent the Federal Reserve Bank of NY or the NY State Bar Association

Why is transparency important?

Hidden Prices!!

# Importance of Transparency

## AS RECOGNIZED BY THE INDUSTRY

- Smart Campaign – Client Protection Principles
  - 2 of the 9 Principles include Transparency, and Responsible Pricing
  - Self-certification, and recently third party certification launched
  - [www.smartcampaign.org](http://www.smartcampaign.org)
- *Banana Skins* reports:
  - Reputation risk (2011) and political interference (2012)
  - These reports are written by practitioners in the microfinance industry based on information received by surveys of various stakeholders
  - Increasing perception that MFIs engage in abusive practices
  - Recognition that abusive practices are not only detrimental to the client but also to the long-term credibility of microfinance
  - <http://www.citigroup.com/citi/microfinance/data/news110125b.pdf>
- Microfinance Rating Agencies
  - Planet Rating/Microrate/Microfinanza: Specialize in rating MFIs
  - Have added (as of 2012) client protection (including transparency, responsible pricing and effective complaint resolution) as a pillar of an MFI rating
  - “An MFI lives in symbiosis with its clients and its asset quality is notably based on the trust relationship created with its clients”. *Planet Rating*
  - “Client protection and other social measures are essential to the long-term success of the business...” *Microfinanza*

# Importance of Transparency

AS REPORTED BY THE SECRETARIAT

- “A recurring theme [of the 1<sup>st</sup> Int’l Colloquium on Microfinance in 2011] was the need for measures to ensure client protection, including the prevention of unscrupulous practices and the building of financial literacy in the community generally”
- “As noted, self-regulation by itself is no longer sufficient and there is an increasing consensus on the need to follow the principles of responsible finance.”
- “More generally the need for transparency (e.g. interest rate disclosure, complaint procedures) in the microfinance sector was flagged.”

Note by Secretariat (summary of First Int’l Colloquium on Microfinance),  
Legal and regulatory issues surrounding microfinance, A/CN.9/727  
(2011)

# Importance of Transparency

## *OTHER REPORTS*

- “Countries with a strong institutional framework for microfinance (as defined by the Microscope) tend to reach more borrowers than countries with weaker institutional conditions. This observation especially holds true for countries with transparent pricing regulations and good dispute resolution mechanisms.”

*Global microscope on the microfinance business environment (2012),  
Economist Intelligence Unit. [www.eiu.com/microscope2012](http://www.eiu.com/microscope2012)*

# Is Self-Regulation Sufficient?

- Misaligned incentives:
  - Creditors/lenders – want to reach more clients
  - Investors – want higher volume and higher returns
  - Client – wants the best deal, but no access to info
- Mandatory participation required for a disclosure regime to work efficiently
  - Self-regulation is voluntary
  - Transparency works best when consistent -- when clients can compare a product across all lenders and receive the same information, ideally in the same format
- No legal enforcement mechanism
  - Reliance on market forces to distinguish among MFIs

# Is Self-Regulation Sufficient?

- No legal enforcement mechanism
    - Reliance on market forces to distinguish among MFIs
  - The main benefits to competition and fair access come from all lenders adhering to the same rules
- Self-regulation demonstrates a commitment to responsible finance, which is an important step for truth-in-lending laws to work effectively



# Transparent to whom?

## Stakeholder:

- Clients
- Investors/Donors
- Regulators
- Other MFIs/Market

## Incentive:

- Client Protection
- Mission-driven
- Compliance; stability
- Facilitate competition

# UNCITRAL Working Group

- UNCITRAL is already active in areas that impact microfinance
  - Secured Transactions: The scope of the Legislative Guide to Secured Transactions includes microfinance transactions when there's collateral
    - It does not, however, address pricing disclosure, or abusive collection
  - Dispute Resolution
  - E-commerce
- Balance “over regulation” with “under regulation”
  - Timing of implementation will be country-specific: legislators, regulators, and local organizations are the best positioned to determine implementation but UNCITRAL is best position to provide standards

# UNCITRAL Working Group

- Potential approaches for a WG on Microfinance and Related Topics:
  - Legislative Guide -- enables legislators and regulators to implement transparency regimes
    - Opportunity to identify best practices among countries and incorporate in to a Guide
  - Model contract provisions
    - Assists implementation of transparency in creditor/debtor relationships

# UNCITRAL Working Group

- Transparency is not an issue of prudential regulation
  - Prudential regulation → safety & soundness of deposit-taking entities, and systemic risk regulation of the macro-economy
    - Prudential regulation already addressed by Basel Committee on Banking Supervision's *Microfinance Activities and the Core Principles for Effective Regulation*
    - [www.bis.org/publ/bcbs175.htm](http://www.bis.org/publ/bcbs175.htm)

# Legal Considerations

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1. Standard Pricing Formulas
2. Standard Repayment Schedules
3. Enforcement & Sanctions
4. Financial Education/Communication Mechanisms

# 1. Standard Pricing Formulas

- Why a standard formula?
  - Beneficial to clients when all lenders use the same formula
  - Disclosure is most effective in increasing competition when there's a standard for all lenders
  - One reason why self-regulation may not be sufficient
- What disclosure standard?
  - Nominal rates: widely dismissed because it does not provide adequate disclosure of the “real” rate
  - APR vs. EIR vs. Total Cost of Credit?
  - Should flat interest rates be prohibited in all cases?
  - Mandatory savings accounts to be included in cost calculations in all cases?

# 1. Standard Pricing Formulas

- What fees disclosed?
  - Best practice would require ALL origination or repayment fees to be communicated
- Other pricing issues to consider:
  - Should all interest on savings be compounded?
  - Security deposits – when is it used as collateral?
- How to best disclose bundled services?:
  - Insurance
  - Mandatory savings; voluntary savings



# 1. Standard Pricing Formulas

- Other Terms & Conditions
  - Prepayment penalties?
  - Variable interest rates?
- Considerations for the working group:
  - How specific should the regulations be? (i.e., what should be left to lender discretion vs. codified in the law?)
  - Should any loan features be prohibited?

# Legal Considerations

1. Standard Pricing Formulas
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## 2. Standard Repayment Schedules

- Why standard?
  - Standard forms make it easier to compare across lenders, irrespective of entity type
  - For illiterate clients, a standard form makes it easier to compare offerings even if they don't necessarily understand all the terms

## 2. Standard Repayment Schedules

- Should forms be mandatory or used at the discretion of the lender (a safe harbor)?
  - Mandatory use will ensure consistency
  - Safe harbor reduces compliance costs and provides opportunity for experimentation
- What level of detail in the forms?
  - Only APR/EIR/TCC?
  - Include cash flow details?
  - Balance of too much info vs. sufficient info (risk confusing clients)



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# Enforcement & Sanctions

- Disclosure regimes will require enforcement & sanctions to be most effective
- Various enforcement regimes & models to be explored by the Working Group:
  - Recommendations will differ based on regulatory landscape & scale of lending in each jurisdiction

# Enforcement & Sanctions

- Example – United States
  - entities that are prudentially supervised are often sanctioned by the licensing or supervisory agency (OCC, FDIC, State Banking Dep't, Federal Reserve) and
  - ALSO subject to supervision by agencies with legal jurisdiction over their activity (Consumer Financial Protection Bureau; Federal Trade Commission); and
  - ALSO can be subject to sanction by the State Attorney General's office



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# Financial Education

- Client Education:
  - Lower-income borrowers are most vulnerable -- lower financial education with respect to bank products
  - May not always know what questions to ask.
  - with transparency pricing, prices may appear higher (because all costs are now included), so clients should be educated on the differences
- Lenders/MFIs may need training on how to comply with disclosure laws
  - Will vary by country and population

# Communication Mechanisms

- Communication of information disclosed should be calibrated to the level of financial education of clients
  - See CGAP Focus Note No. 78 (March 2012), *Designing Disclosure Regimes for Responsible Financial Inclusion I* (where they recommend consumer testing and feedback mechanisms to understand MFI clients).

# Communication Mechanisms

- Communication Mechanisms:
  - Placement of required disclosure:
    - In loan documents? At MFI branches? In newspapers? On websites? Directly to regulators?
  - Working Group to consider complexities of communicating information to lower-income borrowers and their needs
    - Oral communication requirements?
    - Clients be required to acknowledge understanding?
    - Mandate on the timing of disclosure? Cooling off periods?

# Brief Examples of Truth in Lending Legislation

# U.S. Truth in Lending Law

- New Consumer Financial Protection Bureau (CFPB), part of the Dodd-Frank Act
- U.S. truth in lending law focuses only on consumer lending
- Various laws address transparency – the laws are aimed at categories of credit: - for example:
  - Reg C – Home Mortgage disclosure
  - Reg Z – Truth in Lending (consumer loans, including mortgages)
  - Reg B – Equal Credit Opportunity Act (applies to all lending, i.e., anyone who is a “creditor” under the law)
  - Reg E – Electronic Fund Transfers – applies to all entities that hold accounts belonging to a consumer for fund transfer purposes
- CFPB has engaged in an initiative to streamline disclosures – consumers had received too much information

# U.S. Model Form

H-2—Loan Model Form

<b>ANNUAL PERCENTAGE RATE</b> The cost of your credit as a yearly rate.	<b>FINANCE CHARGE</b> The dollar amount the credit will cost you.	<b>Amount Financed</b> The amount of credit provided to you or on your behalf.	<b>Total of Payments</b> The amount you will have paid after you have made all payments as scheduled.
%	\$	\$	\$

You have the right to receive at this time an itemization of the Amount Financed.  
 I want an itemization.     I do not want an itemization.

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments Are Due

**Insurance**

Credit life insurance and credit disability insurance are not required to obtain credit, and will not be provided unless you sign and agree to pay the additional cost.

Type	Premium	Signature
Credit Life		I want credit life insurance. _____ Signature
Credit Disability		I want credit disability insurance. _____ Signature
Credit Life and Disability		I want credit life and disability insurance. _____ Signature

You may obtain property insurance from anyone you want that is acceptable to \_\_\_\_\_ (creditor). If you get the insurance from \_\_\_\_\_ (creditor), you will pay \$\_\_\_\_\_.

**Security:** You are giving a security interest in:  
 the goods or property being purchased.  
 (brief description of other property): \_\_\_\_\_

Filing fees \$ \_\_\_\_\_ Non-filing insurance \$ \_\_\_\_\_

**Late Charge:** If a payment is late, you will be charged \$ \_\_\_\_\_ / \_\_\_\_\_ % of the payment.

**Prepayment:** If you pay off early, you  
 may  will not have to pay a penalty.  
 may  will not be entitled to a refund of part of the finance charge.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

\_\_\_\_\_ e means an estimate

# U.S., continued

- U.S. is heading towards a regime of mandatory forms:
  - “The CFPB believes, based on consumer testing results, that the purpose of more effective advance disclosure of settlement costs is better achieved if all lenders provide those disclosures in a standardized format that consumers can recognize and understand. Moreover, the credit terms included in the Loan Estimate facilitate and enhance the consumer's ability to shop for the best-priced loan, including settlement charges, which have a direct relationship to, and can overlap with, credit terms.” [Federal Register 37(o)(3)]



# Philippines

- Microfinance banks are regulated by *Bangko Sentral ng Pilipinas (BSP)*, although the microfinance market does have other non-bank microfinance lenders, and also traditional commercial banks
  - See The General Banking Law of 2000
  - [www.frbsf.org/publications/.../2010/january.pdf](http://www.frbsf.org/publications/.../2010/january.pdf)
- The Truth In Lending Act (Republic Act 3765) (1963)
  - Applies to all “creditors”
- Flat interest rates are prohibited (July 1, 2012)
- Mandatory disclosure of loan amount, interest and other finance charges

# Philippines

- The truth-in-lending law provides a formula for calculating annual and monthly EIR, which must be published on the loan contract
- Disclosure statement is standardized
- Borrower's rights must be posted on business premises
- Ranked in the *Global microscope on microfinance business environment 2012* as 4<sup>th</sup> (of 55 countries)

# Cambodia

- Law on Banking and Financial Institutions (1999)
  - Identify microfinance lenders as banks
  - Prakas on Microfinance Licensing (2000), provides for compulsory MFI licensing & registration
- Mandatory disclosure of APR/EIR
- Flat interest rates are prohibited
- For savings accounts, compounding of interest is required

# Cambodia

- Pricing information must be published on the MFI websites
- Cambodia is ranked overall at 8 (of 55 countries) by the *Global Microscope on the microfinance business environment 2012*

Thank You!