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Access to credit for micro, small and medium-sized enterprises (MSMEs)

Note by the Secretariat

Contents

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Background information

1. At its at its fifty-second session, in 2019, the Commission agreed to strengthen and complete Working Group I's 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 the Working Group (see also para. 7).[1]

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 preliminary draft materials (defined as the "draft Future Text") contained in a Note by the Secretariat (A/CN.9/WG.I/WP.124) and continued such work at its thirty-seventh session (New York, 9 to 13 May 2022) on the basis of the Secretariat's Note A/CN.9/WG.I/WP.126. At both sessions, the Working Group examined the scope and structure of each section of the "draft Future Text" rather than providing detailed guidance on individual paragraphs, unless there were specific concerns or need to correct inaccurate information.[2]

3. The annex to this document contains a revised version of the draft materials which reflects the deliberations of the Working Group at its last session, in May 2022.[3] The secretariat has made additional adjustments to improve the readability and consistency of the text. Where necessary, paragraphs have been moved and renumbered and any cross references modified accordingly. For ease of reference, the secretariat has maintained those "Notes to the Working Group" concerning issues on which the Working Group has not yet made a final decision (e.g. on whether to add a recommendation to the text). In addition, a few additional "Notes" (or footnotes) have been included to indicate to the Working Group that the secretariat will further research or elaborate on certain topics.

4. Although the Working Group has not yet decided on the particular form that this work should take, the text is meant to provide guidance to policymakers. This is also indicated by the fact that at its last session the Working Group agreed to include legislative recommendations in certain parts of the text. In light of this, the secretariat has replaced the interim term "draft Future Text" with "draft Guide" which better facilitates consideration of this new revision.

1. Purpose

5. The aim of the draft Guide is to assist in the adoption or reform of the domestic legal framework to facilitate access to credit in particular of micro and small enterprises (MSEs) also in light of the difficulties that many of them are currently facing and may continue to face in the future as a result of financial, environmental and other crises, such as climate change or the coronavirus disease (COVID-19) pandemic. For this reason, the draft Guide will also point to new areas that States could regulate or legislate on in order to facilitate MSE's access to credit and it will discuss relevant policy and other support measures to the extent they can contribute to the effectiveness of legislative measures in improving MSEs' access credit. While its main focus is on MSEs, the draft Guide will not completely exclude medium-sized ones and clarify, as appropriate, the different provisions and policy measures applicable to them, as agreed by the Working Group at its thirty-sixth and thirty-seventh sessions.[4]

[1] *Official Records of the General Assembly, Seventy-fourth Session, Supplement No. 17* (A/74/17), para. 192(a). See also A/CN.9/WG.I/WP.125, para. 5 for the verbatim decision of the Commission.
[2] See A/CN.9/1084, paras. 18 and 19 and A/CN.9/1090.
[3] See A/CN.9/1090.
[4] See A/CN.9/1084, para. 26 and A/CN.9/1090, paras. 18 and 19.

2. Intended audience

6. The draft Guide will be addressed both to States lacking a specific legal framework supporting small business access to credit as well as to States aspiring to modernize their existing laws with a view to facilitating access to credit for such businesses including on a transnational basis. In addition to national legislators and policymakers from all geographic regions and legal traditions, international organizations, non-governmental organizations (NGOs), chambers of commerce and other stakeholders that are interested or actively involved in improving the legal framework of access to credit for all sizes and types of MSMEs may also benefit from the draft Guide.

7. At its fifty-second session in 2019, the Commission agreed that the materials prepared by the secretariat should draw, as appropriate, on the *UNCITRAL Model Law on Secured Transactions*, which addresses secured lending using movable assets as collateral (see document A/74/17, para. 192(a)). However, the secretariat should draft those materials in such a way that even those readers who are unfamiliar with the regime contemplated in the Model Law should be able to use and rely on the recommendations of the draft Guide.

3. Working method

8. Following the approach taken by UNCITRAL Working Group V in the preparation of a simplified insolvency regime for MSEs, the discussion on secured lending using movable assets as collateral will build upon the existing UNCITRAL instruments on this topic. These are: the *UNCITRAL Model Law on Secured Transactions* (2016), the *UNCITRAL Legislative Guide on Secured Transactions* (2007) and the *UNCITRAL Legislative Guide on Secured Transactions and its Supplement on Security Rights in Intellectual Property* (2010); the *UNCITRAL Guide on the Implementation of a Security Rights Registry* (2013); the *UNCITRAL Guide to Enactment* (2017); and the *Practice Guide to the Model Law* (2019). The draft Guide will refer to and discuss the recommendations and principles provided for in those texts that are the most relevant to facilitate MSMEs' access to credit.

9. Similarly, the parts of the draft Guide touching upon personal guarantees and restructuring support will cross-refer to the *UNCITRAL Legislative Guide on Insolvency Law for Micro- and Small Enterprises* (2021).

Annex

I. Introduction

1. Micro, Small and Medium-sized enterprises (MSMEs) represent the vast majority of business types in all regions. They account for around 55 per cent of the gross domestic product in developed economies and 35 per cent in developing economies.[1] Worldwide, they make up more than 90 per cent of businesses (in some countries they represent about 90 per cent of the domestic productive sector)[2] and 60–70 per cent of total employment when both formal and informal MSMEs are considered.[3] While MSMEs account for around two thirds of employment in the global economy, their social and economic importance becomes starker in terms of job creation in low-income economies, as much as 95 per cent.[4] As it has been noted,[5] they offer employment and entrepreneurship opportunities for young people, women and disadvantaged groups including migrants, ethnic minorities and persons with disabilities and are therefore crucial in increasing incomes for the poorest 40 per cent of the world's population. The World Bank forecasts that around 600 million jobs will be needed to absorb the youth entering the labour market over the next 15 years.[6] Not surprisingly, several governments have prioritized MSMEs' roles in job creation.

2. Access to financial services is essential for MSMEs, throughout their life cycle. It enables entrepreneurs to start-up, innovate, improve efficiency and productivity and expand their businesses. Access to financial services is sustainable for MSMEs if they can resort to a full suite of financial services, such as payments, savings, credit and insurance, provided at affordable prices and in a convenient manner.[7] Enterprises develop faster in countries with more developed financial markets than countries where businesses do not have the ability to obtain the necessary resources to seize growth opportunities.[8]

3. Access to credit enables MSMEs to make productive investments, which are instrumental to generate income and gain access to additional resources. As noted by the World Bank, lack of or limited access to credit is the second most cited obstacle small businesses face in emerging markets.[9] Various factors affect access to credit and the type of credit that can be obtained including age of the enterprise, gender of the entrepreneur, operation of personal and business bank accounts by the entrepreneur, and availability of business records.

4. MSMEs may access credit through financial institutions operating within the domestic legal and regulatory framework of the financial system. However, small businesses often fail to meet the lending requirements of those financial institutions. In particular, it is difficult for many MSMEs, especially micro and small enterprises (MSEs) to provide valuable collateral or the type of reliable information with respect to their creditworthiness usually required by financial institutions (e.g. lack or insufficient financial reporting).[10] These obstacles are greater for MSMEs operating in the informal sector. Domestic laws may use criteria such as the size of the business,

[1] WTO, World Trade Report 2016, (2016), p. 18.
[2] See for instance Colombia, UNCITRAL fifty-fourth Commission session, TAC panel on 16 July 2021.
[3] ITC, SME Competitiveness Outlook 2015: Connect, Compete and Change for Inclusive Growth, (2015), p. 1.
[4] Ibid., p. 13.
[5] UNDESA, Report on Micro, Small and Medium-Sized Enterprises (MSMEs), and their role in achieving the Sustainable Development Goals, 2020, pp. 4 and 22.
[6] See www.worldbank.org/en/topic/smefinance.
[7] See www.centerforfinancialinclusion.org/microfinance-vs-financial-inclusion-whats-the-difference.
[8] OECD, Discussion Paper, SME Ministerial Conference, 22–23 February 2018, Mexico City, Enhancing SME access to diversified financing instruments, p. 6.
[9] See www.worldbank.org/en/topic/smefinance.
[10] See for general reference IFC, MSME Finance Gap, Assessment of the shortfalls and opportunities in financing micro, small and medium enterprises in emerging markets, 2017.

registration with the social security system or tax authority or business registry to establish the boundaries between formal and informal MSMEs. Consistent with the *UNCITRAL Legislative Guide on Key Principles of a Business Registry*, the draft 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. UNCITRAL's work on reducing the legal obstacles faced by MSMEs in their life cycle aims at facilitating their migration to the formal sector, which in turn should ease MSMEs' access to credit.

5. Even when MSMEs meet the criteria set by the formal financing sector, financial institutions might still be reluctant to issue loans to micro and small enterprises in particular because those loans are often too small to be profitable.[11] This difference between the current supply of finance to small businesses and the potential demand which can be addressed by financial institutions is known as "the finance gap".[12] The International Finance Corporation (IFC) estimates that the unmet demand for financing from formal MSMEs in developing countries reveals a gap of USD 5.2 trillion.[13] According to IFC, there are 65 million, or 40 per cent of credit-constrained formal MSMEs, and the potential demand for finance from informal enterprises in developing countries is valued at another USD 2.9 trillion. While East Asia and the Pacific account for the largest share of the total gap, Organisation for Economic Co-operation and Development (OECD) countries are not entirely free from such gap as a sizeable share of MSMEs in those countries find it difficult to access credit from banks, capital markets or other suppliers of finance.[14]

6. Studies have shown that in most countries the finance gap is likely to be greater for women-run businesses than for men-owned ones because of cultural biases or economic, social and legal constraints.[15] For instance, in some countries women are reported to have less access to affordable credit since they have less physical and reputational collateral,[16] particularly as their microfinance repayment rates are often not captured by private credit reporting service providers.[17]

7. Constrained access to formal credit thus results in many small businesses relying on credit obtained through informal arrangements (see paras. 28 to 34) that may involve higher financial risks or costs and is rarely a guaranteed source of financing. Reduction of the MSME finance gap should thus be treated as a priority at the global and national level. It would also make an impact on achieving the sustainable development goals (SDGs).[18] 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.[19] It further emphasizes that MSMEs can have a positive impact on 60 per cent of the individual SDG targets with sufficient funding in place.[20] Improved access

[11] Z. Chen and M, Jin, Financial Inclusion in China: Use of Credit, 2017, p. 3.
[12] IFC, MSME Finance Gap (supra, footnote 10), p. 2.
[13] This figure is the difference between the potential demand of USD 8.9 trillion minus the credit supply of USD 3.7 trillion. See IFC, MSME Finance Gap (supra, footnote 10), pp. 27 et seq.
[14] OECD, Financing SMEs and Entrepreneurs 2020: An OECD Scoreboard, pp. 26–27; OECD, The SME Financing Gap (vol. I): Theory and Evidence, (2006), p. 15 et seq.
[15] The gap is currently estimated at $1.5 trillion. See IFC and Goldman Sachs, IFC and Goldman Sachs 10,000 Women: Investing in Women's Business Growth, 2019, p. 4.
[16] Reputational collateral (also known as reputation collateral) refers to the ability of the borrower to access credit without providing collateral, but based on the borrower's recognized reputation as a good payer.
[17] ITC, Unlocking Markets for Women to Trade, 2015, pp. 23 and 25.
[18] Inter-agency Task Force on Financing for Development, Financing for Sustainable Development Report 2020, 2020, p. 8, box I.2.
[19] ITC, SME Competitiveness Outlook 2019: Big Money for Small Business – Financing the Sustainable Development Goals, 2019, p. xvi. 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.
[20] Ibid., p. xv.

to credit for MSMEs would allow their potentialities to grow and scale up. This would likely help advance women's economic empowerment and help alleviate poverty.

Reform trends

8. For some time, efforts have been made at global, regional and national levels to facilitate MSMEs' financing. Some initiatives have been broader in scope and focused on promoting MSMEs' access to multiple financial services, for example, facilitating establishing saving accounts or making payments and devising new insurance products. Others have focused on measures particularly tailored to facilitate access to credit. Many of those efforts have prioritized the promotion of hard support policies and regulations aiming at establishing credit guarantee schemes in relation to bank loans and beyond,[21] or direct lending programmes to MSMEs[22] or facilitating the adoption of measures to improve competition within the domestic financial systems and allow a variety of financial institutions to operate.[23] Others have favoured the adoption of soft support policies and regulations including implementation of capacity-building programmes for MSMEs, financers and regulators and strengthening of credit reporting systems.[24] Recognizing that women-owned MSMEs often face higher barriers than those owned by men in accessing credit, global and regional organizations as well as States have implemented many ad hoc policy initiatives to support this category of MSMEs.[25]

9. Many global level efforts in recent years have also drawn particular attention to the role digital financial services and products can play in facilitating access to credit for MSMEs. As recognized by the Group of 20 (G20),[26] the digitalization of financial services is a potential game changer for small business financing since financial processes, including lending, are significantly cheaper, faster and easier.[27] In this regard, it is worth noting that the United Nations through the Task Force on Digital

[21] For example, the European Union has developed several guarantee schemes to support financial institutions in Member States lending to MSMEs (see https://ec.europa.eu/info/business-economy-euro/growth-and-investment/financing-investment/financing-programmes-smes_en). The World Bank and the Asian Development Bank have established technical assistance programmes to improve countries' credit guarantee schemes in support of MSMEs (see for example, www.adb.org/news/adb-loan-help-expand-sme-financing-through-credit-guarantees). China has created a Special Fund for SME Development that supports financing guarantees and a National Financing Guarantee Fund to support the national financing guarantee system (see OECD, Financing SMEs and Entrepreneurs 2020 (supra, footnote 14), p. 168). Bangladesh has also launched an SME Credit Guarantee Fund (see Ministry of Industries of the People's Republic of Bangladesh, SME Policy 2019, p. 5).

[22] The European Union has designed several direct intervention programmes that operate through the local financial institutions that determine the exact financing conditions for the MSMEs (see https://ec.europa.eu/info/business-economy-euro/growth-and-investment/financing-investment/financing-programmes-smes_en). Bangladesh has established an SME Bank (see Ministry of Industries of the People's Republic of Bangladesh, SME Policy 2019, p. 5).

[23] For example, the IFC has advocated for the adoption of policies to improve competition within the financial system and allow a variety of financial institutions to operate as well as to establish government direct lending programmes to MSMEs. See IFC, MSME Finance Gap, (supra, footnote 10).

[24] For example, India has established a national SME Rating Agency that provides comprehensive ratings for use by financial institutions in the assessment of credit. The Agency has recently launched a FinTech platform that facilitates credit flow to MSMEs by providing enterprise-level information (see IFC, SME Finance Policy Guide, (2011), p. 35).

[25] For example, the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) has developed the Catalysing Women's Entrepreneurship programme which includes an Innovative Financing component for the implementation of three key financing mechanisms: a FinTech innovation fund, a women's livelihood bond and an impact investment fund. The component also involves collaboration with policymakers and regulators to support the creation of an enabling policy and regulatory financial environment for women entrepreneurs. See www.unescap.org/projects/cwe.

[26] 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 Head of State and Government.

[27] GPFI, Promoting digital and innovative SME financing, 2020, p. 9. Available at: www.gpfi.org/sites/gpfi/files/saudi_digitalSME.pdf.

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.[28]

10. Finally, several initiatives, in particular at the global and regional level, have encouraged the adoption of modern legislative frameworks in areas that are instrumental to facilitate access to credit for MSMEs, including secured transactions and insolvency proceedings.[29] Other reforms have pursued formalization of small businesses, through simplified incorporation and streamlining business registration (see paras. 162 to 171), that facilitate MSME formation and operation and their access to formal credit sources.

11. The policy, regulatory and legislative reforms mentioned above have generated several best practices that are equally beneficial for countries with different needs and economic conditions. Those best practices address different factors that negatively affect the decision of financers to lend or MSMEs to borrow, for example low creditworthiness of the small businesses, high transaction costs, or unfair contractual practices. It is however important that the legislative instruments and policy and regulatory measures are employed in a complementary and mutually reinforcing way in order to maximize their benefits and design a framework that balances financers protection with increased opportunities for MSMEs to access credit.

12. In particular, coordination between regulatory and private or commercial law instruments is key since they represent two sides of the same coin. Private and commercial law instruments (e.g. contractual safeguards or secured transactions) govern the contractual relationship between financial service providers and MSMEs and provide a framework that reduces the risks of lending for both parties of the transaction. On the other hand, financial regulations are sector-specific rules, often of public law nature, imposed by the State to ensure the safety and soundness of the financial institutions and markets, including the protection of individuals and commercial entities that use financial products. An example of such regulation is the requirement for financial institutions to provide specific types of information in a standardized format on their products or services (e.g. loan rates) to their clients.

13. Private and commercial law instruments and regulatory measures may intersect in their effects and heavily influence the lending behaviour of financial institutions. 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). Such assets are often those more likely to be available to MSMEs, in particular MSEs. On the other side, current law reform initiatives that facilitate access to credit permit the use of a wide variety of movable assets as collateral (see discussion of the *UNCITRAL Model Law on Secured Transactions* in chapter I, section A.1.(a)). This lack of coordination may thwart the effectiveness of a secured transactions regime that may not be applicable to financial institutions, but only to financers outside the regulated financial system. Hence, it is important that the legislature and regulatory authorities recognize the interplay of the frameworks under their purview to ensure protection of the financial markets does

[28] In 2018, the United Nations Secretary-General established the Task Force on Digital Financing for the Sustainable Development Goals as part of its Roadmap for Financing the 2030 Agenda for Sustainable Development: 2019–2021. One of the Task Force's objectives is to ensure that digital financing becomes an integral part of the sustainable development strategies. In its report "People's Money" (2020), the Task Force provides several recommendations to harness digitalization to accelerate financing of the SDGs.

[29] The Financial Infrastructure Development Network established by the Asia-Pacific Economic Cooperation (APEC) actively promotes the development of secured transactions and insolvency frameworks as key elements of an enabling financing environment for MSMEs, including through the promotion of the UNCITRAL Model Law on Secured Transactions (APEC, 2019 Progress Report – Asia-Pacific Financial Forum, Asia-Pacific Financial Inclusion Forum, Asia-Pacific Infrastructure Partnership, pp. 5 ff). In 2015, the G20 identified secured transactions and insolvency frameworks as priority areas to ensure MSMEs' access to credit (see www.gpfi.org/publications/g20-action-plan-sme-financing-implementation-framework).

not undermine the legislative instruments that facilitate access to credit and vice versa.[30]

14. In keeping with the mandate of UNCITRAL, the draft Guide will mainly focus on the domestic legal framework on access to credit and its improvement (e.g. secured transactions or personal guarantees). As it recognizes the complementarity of those instruments with microeconomic (e.g. State subsidies) or macroeconomic measures (e.g. market structure) and regulatory tools, the draft Guide will also discuss relevant policy and support measures to the extent they can ensure effectiveness of the legislative measures in reducing small businesses' constraints to access credit.

15. The draft Guide recognizes that it is often more challenging for MSEs to obtain credit than for medium-sized enterprises, due to their smaller size, availability of human and financial resources, and features (e.g. they often do not have legal personality, and their owners cannot enjoy limited liability protection). While a number of obstacles can be the same for both MSEs and medium-sized enterprises, these latter usually face less and different constraints in their access to credit. Consistent with the principle "think small first", the main focus of the draft Guide is thus on MSEs, although the Guide does not completely exclude medium-sized ones and differentiates, as appropriate, the provisions and policy measures respectively applicable to each of these two categories.[31]

II. MSMEs and their financing needs at various stages

Introduction

16. There is no internationally standard definition of MSMEs, as many criteria may be used to identify them depending on each country's economic, legal, political and social context. Indeed, while the number of employees, turnover, and assets are the more commonly used criteria, other variables, such as formality, years of experience, initial investment amount are also used to define and identify MSMEs.[32] Ultimately, it is for each country to define its own parameters. Mindful of these differences among countries, the UNCITRAL legislative texts on MSMEs do not include a definition for each category of MSMEs, since States will apply the texts in accordance with their own definitions.

17. Despite their varying nature and size, most MSMEs broadly share some common characteristics. They include the following:[33] (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 loans or risk-sharing; (d) limited access to capital; (e) difficult access to banking services; (f) disproportionate impact of regulations (e.g. business registration procedures and cost); (g) limited markets (for MSEs, often only local markets); (h) limited access to formal dispute settlement mechanisms; (i) difficulty to partition assets, so business failure often directly impacts personal and family assets; (j) vulnerability to financial distress; and (k) difficulty in transferring or selling a business.

18. As regards MSMEs' access to credit specifically, two observations can be drawn from these characteristics. First, for many MSMEs, in particular MSEs, there may be no separation of assets between the entrepreneur and the business, particularly in the

[30] The secretariat has added this discussion on the relationship between regulatory and private law instruments relating to access to credit as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 28).

[31] The secretariat has added this paragraph to clarify the scope of the draft Guide, in line with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, paras. 18–19, see also supra, footnote, 4 in the Background Information). The Working Group may wish to note that differentiating which parts of the draft Guide are applicable to MSEs and medium-sized enterprises respectively is still a work in progress.

[32] IFC, MSME Country Indicators 2014: Towards a Better Understanding of Micro, Small, and Medium Enterprises, (2014), p. 5 et seq.

[33] A/CN.9/941, para. 12.

case of sole proprietorship or when the business does not have a distinct legal personality. Second, the limited access to formal financial services often results in strong reliance on informal financial arrangements.[34] Especially women-run MSEs may be dependent on informal sources of credit since, as noted above (see para. 6), they are often more affected than men by the requirements of formal financial institutions: for example service fees or interest rates may be too high in comparison to the sum women wish to borrow or it may be too difficult for them to meet loan repayment conditions. From the financers' point of view, limited access to information on MSMEs, in particular the smaller businesses, and their business operations, or information asymmetry, is one of the most significant problems that hinders external financing, since it is often too costly for them to obtain the information that is needed to assess businesses' creditworthiness.[35]

19. Reforms aimed at improving MSME access to credit should consider those aspects and strike a balance between the lending risk of financers and the need to protect MSMEs, especially the most unexperienced and unskilled ones, against onerous loans, heavy interest fees or other onerous conditions to access credit. To increase financers' confidence in the MSMEs' market, States may adopt measures that enable financers to make better informed lending decisions (e.g. easy access to MSMEs' related information) and facilitate credit recovery in case of MSME default) (e.g. efficient insolvency procedures or enforcement measures). The measures should also make it safer for financers to extend loans through alternative financing mechanisms (e.g. FinTechs), in particular if such mechanism may attract relatively inexperienced fund providers (e.g. crowdfunding).[36]

20. In parallel, States may use a range of regulatory and legislative tools (e.g. public guarantee schemes, secured transactions) to ease MSMEs' financing constraints so that credit remains at affordable rates for them. To maximize their impact, it would be important to tailor such measures to the legal form of MSMEs, for example if they are natural or legal persons. Small businesses may face different financing constraints depending on their legal form. In this respect, it would also be important for States to clarify the scope of the measures as some of them may benefit all MSMEs (for example, laws introducing a modern secured transactions regime addressing the needs of MSMEs), while others may have limitations on eligibility (for example, public credit guarantee schemes).[37]

MSMEs' financing

21. While MSMEs need financing at all stages of their life cycle, the sources of financing may differ according to their stage of development. In the initial stages, when MSMEs (often MSEs) generate little revenue and lack a reliable credit record, access to formal credit is often limited, and entrepreneurs tend to rely on their own savings, support from family and friends (in the form of debt, equity or guarantee) or credit associations (e.g. rotating savings and credit associations,[38] and accumulating

[34] In low-income economies, it is estimated that about 1.7 billion adults who may be already or potentially running MSMEs are excluded from the formal financial system, because they do not have an account at a financial institution or a mobile money provider. These excluded adults amount to 30 per cent worldwide and women are overrepresented among these unbanked. The Working Group may wish to note that the secretariat has replaced reference to "support from family and friends" (para. 4 of A/CN.9/WG.I/WP.124) with "informal financial arrangements" to reflect a wider range of credit options for MSMEs.

[35] World Bank, International Committee on Credit Reporting (ICCR): Facilitating SME financing through improved credit reporting, 2014, p. 1.

[36] OECD, Discussion Paper, SME Ministerial Conference, 22–23 February 2018 (supra, footnote 8), p. 18.

[37] The secretariat has separated the discussion on measures to mitigate creditors' risk and protect MSMEs in this paragraph (para. 18 of A/CN.9.WG.I/WP.126) as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 22).

[38] In this form of transaction the money is put up daily, weekly or monthly and the distribution usually takes place at the end of the month.

savings and credit associations[39]). MSMEs (often MSEs) at initial stages with growth potential and innovative features may attract business angel investors who usually provide funds in exchange for an ownership interest. In some jurisdictions, credit cards, microcredit facilities, credit cooperatives and crowdfunding platforms are also heavily relied upon by small businesses at initial stages. In other jurisdictions, State-owned financial institutions play a key role in extending credit to such businesses.[40]

22. As MSMEs grow and build a reliable credit record, other sources of financing such as commercial credit, factoring, supply chain finance and venture capital (VC) may become increasingly available. Commercial credit in this context refers to the extension of credit by banks or other financial institutions primarily based on the overall creditworthiness of enterprises, and their expected future cash flow is usually considered as the main source of repayment. Factoring and supply chain finance allow MSMEs to increase their cash flow in order to mitigate risks of insolvency and avoid debt since these arrangements are not loans and do not add to a company's debt sheet.[41] VC is a form of private equity. Often VC fund managers make direct investment in unlisted MSMEs, with the aim of bringing capital, technical and managerial expertise to raise the enterprise's value and make a profit at the exit (e.g. by selling the enterprise after some years).[42]

23. For the avoidance of doubt, such classification broadly reflects MSMEs' current preferences concerning access to credit but does not intend to suggest that a certain type of financing sources is used by MSMEs only during a certain stage of development. Indeed, a number of challenges that MSMEs may continue facing throughout their lifecycle (e.g. financial illiteracy or low literacy, see paras. 261 and 263 to 266); high interest rates (see paras. 173 and 174) or the environment in which they operate (e.g. absence of a strong legal and regulatory framework; or informality, see paras. 163 to 171) may also influence their choice of financing sources. Further, certain mechanisms such as those involving microcredit and crowdfunding are often more adapted to the needs of smaller businesses regardless of whether they are at initial stages or not.[43]

24. Notably, other forms of financing may be relevant throughout a MSME's lifecycle, such as Islamic financial products. Islamic financial products are governed by rules and practices derived from the Islamic legal tradition 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).[44] Islamic financial products in the market can be divided into two broad categories: asset-based and equity-based financial products.[45] *Murabaha* is the most commonly used asset-based financing method for MSMEs, under which the financer 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.[46] As regards equity-based Islamic financial products, *Musharaka* is a

[39] In this form of transaction, the sums collected are invested or on-lent against interest thus yielding a net return to the credit association members.

[40] The secretariat has added this sentence on the role of "State-owned financial institutions" as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 23).

[41] At its thirty-seventh session, the Working Group agreed to focus on "working capital finance" rather than "trade finance" (A/CN.9/1090, para. 41). The secretariat has thus deleted refence to trade finance in this paragraph and replaced it with arrangements that can be used to obtain working capital through domestic and cross-border transactions.

[42] The secretariat has deleted the paragraph on medium-sized enterprises and their capacity to access credit through public listing on stock exchange markets or corporate bonds (para. 21 of A/CN.9/WG.I/WP.126) as agreed by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 24).

[43] The secretariat has revised this paragraph (para. 23 of A/CN.9/WG.I/WP.126) in accordance with the Working Group deliberations at its thirty-seventh session (A/CN.9/1090, para. 37).

[44] UNCITRAL Legislative Guide on Public-Private Partnerships (2021), chapter A "Introduction", para. 65.

[45] World Bank – Islamic Development Bank Policy Report: Leveraging Islamic Finance for Small and Medium Enterprises (2015), p. 11.

[46] Ibid., pp. 11 and 13.

straightforward partnership model (i.e. a partnership agreement in which all partners provide capital to a joint venture to share its profits and losses) and shares many commonalities with venture capital.[47] *Musharaka* is rarely used due to the perceived risk of entering into a profit and loss sharing relation with MSMEs, and the key challenges of implementing *Musharaka* are similar to challenges faced by venture capital funds, such as the exit environment (see para. 69 below).[48] Considering that some MSMEs, especially family businesses, may be reluctant to give up ownership of the enterprise, *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.[49] In recent years, Islamic financial products have also been developed in some jurisdictions in the context of crowdfunding and factoring.[50]

25. 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. The Islamic financial products offered to MSMEs generally concentrate on debt financing such as *Murabaha*, which is more suitable for specific financing purposes. More equity-based Islamic financing should 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) there is a lack of collaboration (e.g. shared capital, risk, training) between public and private sectors that offer Islamic financial products. Enhanced collaboration could help attract more stakeholders to participate as capital providers.[51] Moreover, many countries without a tradition of Islamic financing have not put in place a regulatory framework for Islamic financial products. As a result, such products are less standardized and often need to follow the conventional banking rules and regulations.[52]

III. Sources of financing available to MSMEs[53]

26. This chapter focuses on sources of financing introduced in the previous section (categorized as debt and equity tools) and analyses the challenges faced by MSMEs and financers when resorting to them. Several of those funding tools are increasingly provided through digital platforms operated not only by traditional financial institutions but particularly by so-called "new economy actors" such as financial technology firms (FinTechs) and large technology companies (BigTechs) (see paras. 74 to 76). Credit provided through BigTechs is often embedded in platforms whose core business is not offering financial services. For example, several BigTechs active in electronic commerce have established credit lines for the MSMEs selling through their platforms. BigTechs provide credit directly or through a regulated or non-regulated financial provider, their loans are usually short-term, with repayment and interests automatically deducted from the MSME account on the

[47] Ibid., p. 16.
[48] Ibid.
[49] Ibid., p. 17.
[50] EBRD, Smart Contracts, Blockchain and Crowdfunding: How the Law is Getting to Grips with Technology, p. 30.
[51] Asian Development Bank Institute Working Paper Series: Leveraging Islamic Banking and Finance for Small Businesses – Exploring the Conceptual and Practical Dimensions (2020), pp. 18–19. For an overview of the recent development in the Islamic Financial Services Industry in general, see Islamic Financial Services Industry Stability Report (2020), prepared by the Islamic Financial Services Board.
[52] Ibid., p. 18.
[53] The secretariat has combined chapters III and IV of A/CN.9/WG.I/WP.126 into one chapter as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 33).

platform and the MSME inventory stored in the BigTech's warehouse serving as collateral.[54]

27. While modern technology has considerably expanded entrepreneurs' options for accessing credit rapidly and at a convenient cost, many still rely on savings and personal wealth to finance their business even beyond its initial stages. Regardless of whether used as a debt or equity tool, relying on personal funds usually makes it impossible any separation of personal and business assets, in particular if entrepreneurs use their personal accounts for business purposes too. This practice not only increases the risks of over-indebtedness, but also affects entrepreneurs' credit profile and history, and often prevents MSMEs from accessing adequate financial products. On the financers' side, it impedes banks from properly monitoring business credit, since it is often indistinguishable from the credit the entrepreneur obtains for personal or family use.[55,56]

A. Family and friends support[57]

28. Microenterprises often rely on family and friends for initial capital[58] and sometimes continue such reliance even beyond that stage.[59] For example, many women-owned enterprises in low-income countries do not have access to formal credit, and finance their business mainly through loans from family and friends as well as personal savings.[60]

29. Family and friends support can come in the form of gift, debt, equity or guarantee. While gift, debt and equity are direct financial contributions to the MSME, a guarantee is a form of indirect support, with a family member or a friend committing to honour the debt in the case the MSME borrower fails to pay its debt (see paras. 153 to 158).

30. From the perspective of the MSME, direct financing from family and friends offers advantages in comparison with conventional sources of funding, in particular in case of short to medium-term borrowing. Given their personal relationship with the entrepreneur, family and friends may be more willing to provide financial support than financial institution often even without requiring collateral to secure loans or detailed business plans or other documentation in the case of equity. In addition, the loan or investment terms may be flexible and often cover a longer period as compared to commercial credit. When the support comes in the form of debt, its timely

[54] As agreed by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 75), the secretariat has moved here, with editorial adjustments, the discussion on electronic platforms from the section on FinTechs (paras. 143 to 145 of A/CN.9/WG.I/WP.126).

[55] OECD, Financing SMEs and Entrepreneurs 2022, an OECD Scoreboard, p. 33.

[56] The secretariat has added this discussion on the use of personal wealth to finance MSMEs as agreed by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 33).

[57] At its thirty-seventh session, the Working Group agreed to give special attention to the issue of family and friends support (A/CN.9/1090, para. 37). The secretariat has thus: (i) expanded the discussion on the advantages and disadvantages of this source of financing; (ii) added reference to support in the form of gift; (iii) referred to lack of specific laws or regulations on financing from family and friends; and (iv) highlighted the importance of financial literacy as well as measures facilitating access to formal sources of credit. For improved consistency of the draft Guide, the secretariat has also combined the two sections on family and friends support (debt and equity) into one.

[58] Inter-agency Task Force on Financing for Development (supra, footnote 18), p. 67; UNESCAP, Small and Medium Enterprises Financing (2017), p. 3.

[59] A survey by the Consultative Group to Assist the Poor (CGAP) indicates this this practice is common for small businesses. See CGAP, Executive Summary – CGAP National Surveys of Smallholder Households (2018), p. 15. The Working Group may wish to note that the secretariat has deleted the second sentence ("Based on … and friends") of this paragraph (para. 26 of A/CN.9/WG.I/WP.126) for improved clarity of the text.

[60] The World Bank reports that according to a survey of women-run businesses in the Middle East and North Africa, most women owners did not have access to formal credit and financed their businesses mainly through savings, loans from family and friends, and by reinvestment of their business earnings. See World Bank, Secured Transactions, Collateral Registries and Movable Asset-Based Financing (2019), p. 23.

repayment may help the entrepreneur to build credit history and obtain commercial credit more easily.

31. However, direct support from family or friends often comes on an informal basis. Terms are often agreed orally rather than being written down which may easily make this source of financing unreliable and untimely and also result in significant non-financial costs.[61] Oral agreements often lack clarity on the terms and conditions of the loan, repayment schedules and remedies for defaults. They may also be misleading as in some cases a loan may be taken for a gift and in certain countries this might have tax implications for the MSME or the donor or both.

32. When family and friends' support is in the form of equity, which is usually associated with decision-making rights in the business, informal agreements on the terms of the investment may affect the MSME governance, and the liability of its members, including whether and how the funds' provider(s) can modify or sell their stake. It should be noted that in some countries, the amount of funds raised for MSMEs at initial stages[62] through family and friends generally exceeds other private equity sources (e.g. VC and business angel investments) and in certain countries MSMEs would rely more on family and friends throughout their life cycle.[63] Family and friends are part of the entrepreneur's close social network and they do not have the same concerns as professional investors in terms of risk assessment.[64]

33. In most countries there are no specific laws or regulations applicable to family and friend's debt and equity support. Both informal debt and equity investment from family and friends are generally subject to existing rules framework governing commercial contracts and dispute resolution (to the extent that some kind of oral or written agreement can be proved for informal debt and investor's rights and obligations are set out in a contract in the case of equity investment). Moreover, corporate law in particular rules on corporate governance and other non-contractual issues would normally apply to equity support by family and friends. Finally, in countries where financial support from family and friends is strongly linked to the domestic societal structure, local customs and practices might be more relevant than commercial law.

34. While many countries recognize the importance that direct financing from family and friends be reliable and transparent for all parties involved, many of them may find policy measures a better tool to achieve this goal rather than developing an ad hoc legal framework. In most countries, the general mechanisms governing the relationships between the MSME and its creditors and other third parties would also apply to financing from family and friends. Instead, since lack of awareness about their mutual rights and obligations is often at the root of the problems arising between the entrepreneur and family members or friends providing credit, many States may opt for strategies to improve financial literacy of the parties (see paras. 261 to 270). Even when the parties are aware of their mutual rights and obligations, personal ties might still lead entrepreneurs and family and friends to ignore basic due diligence about the risks they are assuming or neglect to formalizing their agreements in a manner that provides adequate record for future reference. Putting in place measures that increase formal financing options for MSMEs (e.g. public credit guarantee schemes, a modern secured transactions regime, but also facilitating MSMEs' formalization) could thus be particularly important, as they would permit less reliance on family and friends.

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[61] See S. Djankov, I. Lieberman, J. Mukherjee, and T. Nenova, 2002, "Going Informal: Benefits and Costs." In Boyon Belev, ed., The Informal Economy in the EU Accession Countries. Sofia: Center for the Study of Democracy, pp. 63–80.

[62] For example, the United States of America. CGAP, Executive Summary (supra, footnote 59), p. 21. Further, according to a survey of the European Central Bank, 18 per cent of European small and medium-sized enterprises (SMEs) identified funds from family, friends or related companies as relevant sources of financing for them. See European Central Bank, Survey on the Access to Finance of Enterprises in the euro area: April to September 2019, 2019, p. 18.

[63] See ITC, SME Competitiveness Outlook 2019 (supra, footnote 19), p. 21.

[64] CGAP. Executive Summary (supra, footnote 63), p. 24.

B. Debt tools

1. Credit cards

35. Credit cards are not new and are generally available for MSMEs in most jurisdictions. 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 granted on a business credit card is often higher than a personal credit card. Certain credit cards issued by development banks 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.

36. The issuance of credit cards is usually subject to existing laws and regulations governing commercial 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 for MSMEs are generally tailored to accommodate the financing needs of small business owners, commercial banks may impose high interest rates and high default charges for credit cards issued to MSMEs. Moreover, many small business credit cards require a personal liability agreement to hold business owners liable for any late or missed payments. Small business credit cards also often carry 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.

2. Microcredit

37. Microcredit (also known as "microloan") is a common form of microfinance that involves an extremely small loan often given to an individual or microenterprise to start businesses. These borrowers tend to be low-income, especially from less-developed countries. The structure of microcredit arrangements frequently differs from traditional banking and there might not be a written agreement at all. In some instances, the microcredit was 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 collateral, microcredit providers often pool borrowers together which creates a form of peer pressure to help ensure repayment. In some jurisdictions, microcredit providers that meet certain requirements are subject to regulatory rules concerning registration and reporting.

38. Microfinance institutions (MFIs) constitutes 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. MFIs are less demanding in terms of collateral and guarantee requirements and offer more personal, tailor-made and simple financial products, but they do not always charge lower interest rates than other sources.[65] Loans are often the first product that MFIs offer to clients.[66] Microfinance has made a major

[65] European Investment Fund, European Small Business Finance Outlook, 2019, p. vi.

[66] Other products MFIs may offer to micro-businesses include savings, micropensions, microinsurance, emergency loans, leasing and grants. See International Labour Office, Making Microfinance Work: Managing Product Diversification (2011), p. 112.

contribution to improve microenterprises' access to credit,[67] particularly for businesses run by women. Eight out of every ten microfinance clients in the world are likely to be women entrepreneurs.[68]

39. Generally, less stringent prudential regulations apply to MFIs compared with traditional financial institutions.[69] The extension of microcredit is mainly subject to existing laws and regulations governing commercial 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 and regulatory issues surrounding microfinance. They include: (i) a lack of transparency in microfinance product pricing; (ii) the absence or lack of government intervention, in particular in setting limits on the interest rate charged on loans; (iii) disproportionate collateral requirements, resulting in abusive collection practices by some MFIs; (iv) absence of or poor measures to ensure client protection and prevention of unscrupulous practices; (v) poor financial literacy in the community generally; and (vi) lack of regulation on the wide range of institutions that provide microfinance services.[70]

40. In addition, the strict payment structures of some microloans may also prevent microenterprises from using them for the higher-risk and longer-term investments essential to their growth. Furthermore, while digitalization of microfinance operations proves to be efficient, MFIs are only partially digitalized across the world. Moreover, in some countries digital transactions may be stalled by poor infrastructure[71] or MSMEs' lack of appropriate devices to benefit from the opportunities of digitalization (for example, smartphones to access digital mobile credit).[72]

3. Credit co-operatives

41. According to the Statement on Co-operative Identity adopted by the International Co-operative Alliance,[73] "[a] co-operative is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise." Self-help, self-responsibility, democracy, equality, equity, and solidarity are the core values of co-operatives. As a particular type of co-operative, credit co-operatives (also known as credit unions or credit associations) are defined as non-profit associations whose members deposit their savings in a common pool with the aim of creating a fund to satisfy the credit needs of their members. Their purpose is not to make profits, but to provide services at the best rates compatible with the sustainability of the organization.

42. There are various types of credit co-operatives (e.g. rotating savings and credit associations, and accumulating savings and credit associations) that share the key feature of being member owned. While some credit co-operatives are informal and

[67] According to the Microfinance Information Exchange (MIX), the gross loan portfolio for microenterprises in 2017 (i.e. 762 financial service providers operating in the microfinance sector of 103 developing markets) was around $34 billion. Importantly, the MIX data differentiated the financing needs of microenterprises from the financing needs of the owners of such businesses. The gross loan portfolio for household financing constituted a separate category, amounting to roughly $29 billion. In Europe, the latest market survey data showed that total microloan portfolio outstanding in 2017 reached €3.1 billion reported from 136 MFIs. See Microfinance Information Exchange, Global Outreach and Financial Performance Benchmark Report – 2017–2018 (2019), pp. 36 and 38.

[68] World Bank, Secured Transactions (supra, footnote 60), p. 23.

[69] The secretariat has added reference to the less stringent prudential regulation requirements as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 39).

[70] A/CN.9/727, paras. 29 to 52; A/CN.9/780, para. 37.

[71] European Investment Fund (supra, footnote 65), p. vi.

[72] The CGAP National Surveys of Smallholder Households (2018) reports, for example, that mobile money is the most important formal financial tool, yet few smallholder households in the surveyed countries own smartphones. This survey studied the financial lives of smallholder households in Bangladesh, Côte d'Ivoire, Mozambique, Nigeria, Tanzania and Uganda. See CGAP, Executive Summary (supra, footnote 59).

[73] See International Co-operative Alliance web page on "Cooperative identity, values & principles".

only consist of a few members in the same neighbourhood, other credit co-operatives are registered associations with their own statutes, some even with banking license. For example, in Europe, co-operative banks are a popular form in the co-operative sector, which often provide credit to households, individual entrepreneurs and local small and medium-sized enterprises.[74] Customers can become members of co-operative banks and are involved in the governance, strategy and risk management processes. The key principle of governance is "one person, one vote". The objective of co-operative banks is to create value for their members and to maintain a long-term relationship of trust, rather than the profit maximization goal of other commercial banks.[75] Cooperative banks are owned by the customers and often offer more favourable interest rates compared with other commercial banks.[76]

43. In Francophone countries of Africa, *tontines* function in an informal but similar manner as credit co-operatives and constitute an important source of financing for micro enterprises. *Tontines* refer to arrangements where a small group of individuals form a group and select a leader who periodically (e.g. daily, weekly) collects a given amount from each member, and the money collected is given in rotation to each member of the group, either through auction or in a pre-determined order.[77] Penalties may be imposed on members who fail to pay their contributions on time. The main purpose of the *tontines* is to save money and obtain credit. While some *tontines* are informal groups among friends and neighbours, other *tontines* may be registered associations with their own statutes. Traders in Africa, particularly women, often participate in one or more *tontines* in order to finance their businesses. 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. Individual *tontines* often serve as a saving vehicle only.

44. Debts extended by credit co-operatives are also subject to the existing frameworks relevant to commercial law concerning contract formation and dispute resolution, to the extent that the relationship between the MSME borrower and credit associations can be proved. In some jurisdictions, the operation of credit co-operatives is also subject to specific laws and regulations. Credit co-operatives 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 co-operatives 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 co-operatives if a member defaulted.[78] Even for cooperative banks, membership is typically 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.[79]

[74] European Investment Fund Working Paper 2016/36, The Role of Cooperative Banks and Smaller Institutions for the Financing of SMEs and Small Midcaps in Europe, p. 14.

[75] See European Association of Co-operative Banks web page on "Characteristics of the co-operative banking model"; European Investment Fund Working Paper 2016/36 (supra, footnote 74), p. 10.

[76] European Central Bank Working Paper Series No. 1568, Bank Lending and Monetary Transmission in the Euro Area (July 2013), p. 7, footnote 4.

[77] See generally International Labour Office (ILO) Working Paper INT/92/M01/FRG, Tontines and the Banking System – Is There a Case for Building Linkages?.

[78] IFC, Research and Literature Review of Challenges to Women Accessing Digital Financial Services (2016), p. 10.

[79] European Central Bank (supra, footnote 76), p. 7, footnote 4.

4. Commercial credit[80]

45. Commercial credit in this context refers to the extension of credit by banks or other regulated financial institutions primarily based on the overall creditworthiness of enterprises, and their expected future cash flow is usually considered as the main source of repayment (also known as "traditional lending"). The demand from MSMEs (often small and medium-sized enterprises) for commercial credit in the form of traditional lending can vary significantly from one country to another even in the same geographical region.[81] The reasons differ across countries and are often related to the adoption or 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).[82] In general, the share of MSMEs' loans remain lower in emerging and middle-income countries. This reflects, inter alia, a high level of business informality as well as the large portion of small business owners who request credit on their personal accounts to operate their business (see para. 27).[83,84] Existing laws and regulations governing commercial contracts and dispute resolution, as well as the existing regulatory framework concerning the operation of banks need to be taken into account when extending commercial credit. Specific challenges that limit this form of credit to MSMEs in some countries largely relate to the difficulties that financers encounter in assessing and monitoring the creditworthiness of MSMEs. Firstly, information asymmetry due to MSMEs' lack of supporting financial information infrastructure limits financers' ability to lend.[85] MSMEs often lack the expertise and skills needed to produce adequate financial statements. As a result, financers only have access to limited documentation on the activities and financial status of MSMEs. They are also likely to incur high due diligence costs relative to the size of the loan.[86] Financers typically lend based on an enterprise's credit history but if an enterprise cannot access credit in the first place, it becomes very challenging to build the necessary credit history and profile.

46. In order to mitigate credit risk, financers often impose strict collateral and guarantee requirements on MSMEs.[87,88] In some jurisdictions, land is one of the collaterals used in financing for MSMEs, especially for farmers. Whereas movable assets (e.g. machinery, equipment or receivables) may account for most of MSMEs' capital stock, financers are often reluctant to accept them as collateral where secured transactions laws and collateral registries are outdated, non-existent or where it is otherwise difficult to identify or seize collateral.[89] Credit guarantees in support of loans extended to MSMEs are difficult to obtain in the absence of public guarantee schemes and a network of local or sectoral guarantee institutions for MSMEs[90] (see paras. 173 to 203).

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[80] The secretariat has replaced the phrase "bank credit" with "commercial credit" here and elsewhere in the draft Guide as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 28). The Working Group may wish to note that the secretariat, subject to the deliberations of the Working Group at its thirty-ninth session (Vienna, 19 to 23 September 2022) may further revise (i.e. simplify) this section in the next iteration of the draft Guide.

[81] In 2018, for example, Chinese SMEs were far more likely to apply for credit (58.36 per cent) than SMEs in Indonesia (3.35 per cent). See OECD, Financing SMEs and Entrepreneurs 2020 (supra, footnote 14), p. 33.

[82] OECD, Financing SMEs and Entrepreneurs 2022 (supra, footnote 55), p. 33.

[83] Ibid.

[84] The secretariat has revised the second part of this paragraph (para. 38 of A/CN.9/WG.I/WP.126) to clarify the reasons for low share of MSME's loans.

[85] World Economic Forum, The Future of FinTech: A Paradigm Shift in Small Business Finance (2015), p. 9.

[86] Inter-agency Task Force on Financing for Development (supra, footnote 18), p. 64.

[87] As cited by one IFC report, data from the World Bank Enterprise Surveys show that nearly 79 per cent of loans or lines of credit required collateral. This figure was similarly high in most regions of the world. See IFC, MSME Finance Gap (supra, footnote 10), p. 44.

[88] The secretariat has deleted the second sentence of this paragraph and moved it in a footnote (supra, footnote 91) to limit reference to time-bound data.

[89] IFC, MSME Finance Gap (supra, footnote 10), p. 44.

[90] European Investment Fund (supra, footnote 65), p. 62.

47. Last but not least, a lack of competition among financers reduces access to credit for MSMEs.[91] In many developing countries with less competitive banking sectors, banks are more likely to charge higher service fees and have fewer incentives to service MSMEs.[92] Notably, the establishment of digital challenger banks (typically offering financial services with no physical presence) in several countries has attracted more MSMEs by charging transparent and low fees, providing faster services, and enhancing user experience through their digital interfaces. [93] Nevertheless, compared with larger enterprises, interest rates still remain high for MSMEs.[94] As discussed in paragraph 6 above, women entrepreneurs may face more difficulties in accessing commercial credit due to legal, institutional and sociocultural factors. Internationally collected data reveal that women are less likely than men to have bank accounts. 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 limited financial or formal education, women often lack access to other formal financial services, such as savings, digital payment methods, and insurance.[95] It was reported that due to a lack of formal financial transaction records, there is frequently no credit information about women entrepreneurs for the purpose of risk assessment (see para. 209), which further restricts their ability to obtain commercial credit.[96] In some countries, there exists a mistrust among women with respect to banks that also affects their willingness to use services of banks and other regulated financial institutions.[97]

48. It may be difficult for States to mandate commercial banks to support MSMEs with stronger lending policies such as: allocating a percentage of the bank's loan portfolio to the MSME segment; [98] sharing the burden of MSMEs in financial difficulty through mandatory moratoria in specific circumstances; or applying them preferential policies (e.g. lower interest rates). Given their profit-driven nature and ownership structure, it is unlikely for commercial banks to adopt lending policies that may not ensure adequate financial returns and might compromise their shareholders' gains. In certain countries, governments have successfully incentivized commercial banks' lending to MSMEs through measures such as increasing funds for public guarantee schemes (see para. 45), facilitating MSME loan restructuring or establishing bridge loan programmes or programmes that provide low-cost funding. These measures reduce banks' credit risks and make it more attractive for them to sustain their transactions with MSMEs.[99]

5. Financial lease[100]

49. Leasing is an asset-based financing tool that businesses in many countries utilize to fund the use and eventually purchase of equipment or other assets. Under a lease

[91] IMF, Financial Inclusion of Small and Medium-Sized Enterprises in the Middle East and Central Asia, 2019, p. 13.

[92] Inter-agency Task Force on Financing for Development (supra, footnote 18), p. 64.

[93] For example, Brazil, China, Germany and the United Kingdom of Great Britain and Northern Ireland. See OECD, Financing SMEs and Entrepreneurs 2020 (supra, footnote 14), p. 50, box 1.2.

[94] In 2018, for instance, SME interest rates in a number of middle-income countries (e.g. Brazil, Colombia, Mexico, Peru and Ukraine) were near 17 per cent, and even in high-income countries (e.g. Chile and New Zealand) the SME interest rates were close to 10 per cent. Ibid., pp. 28–29.

[95] World Bank, "Expanding Women's Access to Financial Services", website, available at: www.worldbank.org/en/results/2013/04/01/banking-on-women-extending-womens-access-to-financial-services.

[96] IFC, MSME Finance Gap (supra, note 10), p. 44.

[97] The secretariat has deleted the final sentence of this paragraph (para. 42 of A/CN.9/WG.I/WP.126) to avoid redundancy.

[98] However, in the Philippines, the "Magna Carta for MSMEs" law mandated all banks to allocate a specified percentage of their loan portfolio to MSMEs imposing fines for failure to comply with such mandatory credit allocation.

[99] The secretariat has added this discussion on the role of States to incentivize bank lending to MSMEs in line with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 40).

[100] The secretariat has added this section on financial lease (finance lease) as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 43).

agreement, the owner (i.e. lessor) of the asset grants the business (i.e. the lessee) the right to use it for a given period of time upon (usually) monthly lease payments. 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 the related obligations such as maintenance and insurance[101] although the lessor retains title to the asset. The lessee has the option (not the obligation) to purchase the asset for a nominal price at the end of the lease term and to be transferred the title. Under some forms of financial lease, the title to the asset is transferred to the lessee automatically at the end of the lease term.[102]

50. Financial lease is a form of short to medium-term financing that businesses use for long-lived assets, instead of entering into long-term loans to purchase them.[103] It allows MSMEs to preserve cash resources as it requires no or limited down payment or security deposit. This feature makes it a valuable option for start-ups without the necessary funds to buy equipment or MSMEs that do not qualify for commercial credit due to high risk or lack of collateral. Financial lease can also be profitable for MSMEs in financial difficulties, in particular when the leased asset permits to generate cash flow.[104] However, leasing can become more expensive than an outright purchase due to the cost of the leased asset over its economic life. Furthermore, MSMEs' failure to comply with its monthly lease payment may result in the asset loss, which could compromise the MSME sustainability on the market.

51. Leasing does not require States to develop a strong lending infrastructure. However, it might be difficult to support it in the absence of a country-based asset registry, which would mitigate the risk of illegal selling of leased assets, or if laws on repossession are weak since this can undermine the ability of the lessor to repossess the asset in case of MSME default.[105] Further, inadequate norms on the formation and operation of leasing companies may result in high leasing costs. Leasing companies are often non-deposit taking institutions and they are subject to less stringent capital requirements than banks. While this may allow them more flexibility, on the other side it may also constrain them to source funds from more volatile and expansive markets. Certain countries mitigate this risk by imposing minimum capital requirements on non-bank lessors, implying limitation of lending to a proportion of their net asset value.[106]

52. In terms of regulated financial institutions' ability to provide SME financing in the form of leasing (or loans), one of the major constraints (apart from the availability of liquidity) may be the limitations resulting from local prudential regulations regarding minimum regulatory capital to be retained by such lenders. Consequently, existence of legislative and regulatory tools enabling optimization and freeing up of regulatory capital can have a positive knock-on effect on financial institutions' capacity to support MSMEs and on the availability of financing. Based on the regulatory capital released, a financial institution can then use the freed-up regulatory capital to generate a new portfolio of MSME leases (or loans), thus enhancing MSME access to credit. Active management of regulatory capital adequacy can be achieved by way of portfolio guarantees, risk-sharing arrangements or synthetic or true-sale securitization transactions. While these instruments rely to a large extent on standard civil and commercial law provisions, for all of them the existence of a robust legal framework enabling the transfer of risk on an existing portfolio to a third party, as well as the regulatory recognition of such instruments, is required.

[101] OECD, New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, 2015, para. 128.
[102] See UNCITRAL Legislative Guide on Secured Transactions, 2007, Introduction, para. 26.
[103] OECD, New Approaches (supra, footnote 101), para. 128.
[104] Ibid., para. 136.
[105] Ibid., para. 139.
[106] Ibid., para. 140.

6. Public financial institutions (or, State-owned financial institutions)[107]

53. In many countries, there are public financial institutions that supply financial services to underserved groups, including small businesses, and play an important countercyclical role to mitigate financial markets' crises.[108] Some of these institutions act as commercial banks mandated to directly lend to MSMEs; others are "second-tier" lenders which fund commercial banks and other financial institutions that will then extend credit to MSMEs; yet others combine both direct and indirect lending functions.[109]

54. Public financial institutions make it possible for MSMEs to access credit more easily than their commercial counterparts since they are less selective in their strategies towards small businesses and are willing to take up more risks.[110] 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.[111] Generally, public financial institutions can offer MSMEs below market-rate loans, require less or no collateral at all and have more transparent lending policies.

55. However, public financial institutions may be subject to strict audit, reporting and documentation requirements that may make them less agile than commercial banks in satisfying MSMEs' applications.[112] 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. Some States have thus introduced measures to enhance accountability of public financial institutions, for example ensuring that clearer institutions' mandates and strong governance structures are in place, and introducing appropriate government processes for the provision of financial support to the institutions.[113]

7. Working capital finance[114]

56. Adequate levels of financial resources (i.e. working capital) are key for MSMEs' existence and operations. Working capital helps to meet short-term expenses that cannot be delayed, for example purchasing raw materials or paying salaries, as well as to face emergencies and maintain solvency. This ensures MSMEs' survival and sustainable growth. A broad range of arrangements are available to generate working capital, some of which (e.g. letters of credit) are particularly relevant for MSMEs, mainly small and medium-sized ones, active in cross-border trade; others (e.g. factoring, supply chain, warehouse receipt financing) may also be used in

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[107] The secretariat has included this section on public financial institutions (also known as State-owned institutions) as requested by the Working Group at its thirty-eighth session (A/CN.9/1090, para. 23, see also supra, footnote 40).

[108] OECD, Evolution and Trends in SME Finance Policies since the Global Financial Crisis, 2020, p. 20.

[109] Ibid.

[110] GPFI and IFC, SME Finance Policy Guide, 2011, p. 50.

[111] IMF, Fiscal Affairs, Public Banks' Support to Households and Firms, 2020, p. 2. Available at: https://www.imf.org/en/Publications/SPROLLs/covid19-special-notes#fiscal.

[112] GPFI and IFC, SME Finance Policy Guide (supra, footnote 110), p. 50.

[113] IMF, Fiscal Affairs, Public Banks' Support to Households and Firms, (supra footnote 111), p. 3.

[114] In keeping with deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, paras. 41 and 42), the secretariat has: (i) replaced the heading "Trade finance" with the current one; (ii) deleted reference to "trade finance" in this section and elsewhere in the draft Guide; (iii) refocused the discussion in paragraph 56 (para. 43 of A/CN.9/WG.I/WP. 126) on tools for working capital financing and how their use can be prompted by long "payment schedules"; (iv) deleted references to "importers" and "exporters" throughout the section; and (v) added paragraphs on "warrantage" and letters of credit. In addition, the secretariat has included a paragraph on warehouse receipt financing, as "warrantage" is a particular type of warehouse receipt financing.

domestic trading; yet others (e.g. warrantage) are mainly intended for the domestic market.

57. Conditions of payment in their customer-contracts may determine MSMEs' decisions to use those arrangements. MSMEs are particularly vulnerable to long-term payment schedules as they may considerably reduce their cash flow thus affecting their operations. Long payment terms in substance are equivalent to an interest-free loan the MSME is granting to its customers (which may easily include large corporations) and can also reduce the MSME ability to access credit. Assuming an MSME has taken out a loan, until it receives payment of its invoices to customers, it will incur in interest costs on the loan that will not recover on the paid invoices. Arrangements such as factoring or supply chain finance (and in cross-border transactions, letters of credit) can thus help MSMEs preserve their viability on the market and ability to access credit if they cannot negotiate shorter payment schedules.

58. **Factoring** is traditionally used to finance the activities of small and medium-sized enterprises by purchasing receivables. As explained in the *UNCITRAL Legislative Guide on Secured Transactions* (2007), factoring is a form of receivables financing which generally involves the outright sale or assignment of receivables by the grantor as seller (commonly called the assignor) to the factor (commonly called the assignee).[115] In order to decide whether to purchase receivables, the factor primarily focuses on the creditworthiness of the grantor's customers and the enforceability of rights to payment evidenced by the invoices rather than on the financial statements, fixed collateralizable assets or credit history of the seller.[116] Given that MSMEs may have more creditworthy enterprises as customers, the factor can purchase receivables at better terms than it would if the exposure were on the riskier MSMEs.[117] It was reported that in some jurisdictions post-dated cheques were used under factoring contracts to strengthen the enforceability of rights to payment.[118] In some other jurisdictions, the sale of non-performing receivables by MSMEs in order to benefit from an immediate flow of liquidity is also referred to as "debt purchase". Such receivables are sold at a discount, and the purchase price is paid immediately upon conclusion of a debt purchase contract, regardless of debt collection success.

59. **Supply chain finance** is defined as the use of financing and risk mitigation practices and techniques to optimize the management of the working capital and liquidity invested in supply chain processes and transactions.[119] It is likely to be used in relation to "open account" trade where the buyer and seller have an existing business relationship[120] and the supply chain finance "add-on" is the interposition of a bank or FinTech company (see paras. 131 and 132) 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. In practice, MSMEs are often sellers based in a developing country, supplying to a large buyer in North America, Europe or Asia. Supply chain finance provides MSME suppliers with a range of options for accessing affordable financing (such as receivables discounting,

[115] UNCITRAL Legislative Guide on Secured Transactions (supra, footnote 102), para. 31.

[116] 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). Ibid., para. 32; see also OECD, New Approaches (supra, footnote 101), para. 97.

[117] IFC, MSME Finance Gap (supra, footnote 10), p. 45.

[118] Summary Report of the Third Session of the Unidroit Factoring Model Law Working Group, Study LVIII A – W.G.3 – Doc. 4 (July 2021, para. 8). The Working Group may wish to note that this sentence has been inserted following the suggestion of the Working Group to address the use of post-dated cheques(A/CN.9/1084, para. 40), which, in the view of the secretariat, is more relevant for the issue of factoring rather than personal guarantee.

[119] ICC, Standard Definitions for Techniques of Supply Chain Finance (2016).

[120] ICC Academy, "Supply Chain Finance: An Introductory Guide", website, available at: https://icc.academy/supply-chain-finance-an-introductory-guide.

forfaiting, distributor finance and pre-shipment finance),[121] 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 facilitate favourable financing options for their MSME suppliers, by explicitly confirming deliveries and resulting payment obligations to a factor.[122]

60. **Warehouse receipt financing** is a mechanism, in certain countries regulated for over a century,[123] that allows the use of commodities as collateral to secure loans. Warehouse receipt financing is appropriate for all types of commodities, but it is particularly suitable in agriculture. It can especially benefit small holder farmers in low income countries, since they can store their commodities at a warehouse and after a quality check receive a receipt (specifying the quantity and quality of the commodities) that they can use as collateral to access loans from financial institutions. This does not preclude the farmers from selling the commodities on the market when the prices are more convenient for them. Warehouse receipt financing is advantageous for financers too, since it helps reduce their lending risks. However, in the case of private warehousing,[124] the MSME owner of the stored commodities maintains the effective and legal possession of the goods. This may pose a risk to financers, since despite receiving the warehouse receipt they might not make the security right effective against third parties.[125] It should be noted that an efficient system of warehouse receipt financing not only rests on a modern legislation but also on adequate infrastructure and secondary markets for the sale of collaterals as well as an effective supervisory system.

61. In some African countries, a form of inventory credit based on similar principles of warehouse receipt financing exists, although in **warrantage** (this is the term) there is no tradable receipt. Warrantage permits farmers to store their commodities at postharvest time in a (small) warehouse, usually jointly managed by a farmers' organization and a financial institution and located in their own village. A farmer can use the stored commodity as collateral for up to 80 per cent of the loan amount over a pre-determined storage period and at a pre-determined annual interest rate. After the storage period, the farmer can collect and sell the commodity and repay the loan or a buyer may collect the goods and directly repay the financial institution. As in the case of warehouse receipt financing, warrantage can improve farmers' access to credit since farmers can rely on the stored goods as collateral and cope with high-season price fluctuations[126] (so that they can sell the goods at the most convenient time). It also reduces the risk in lending of the financial institution, as the participation in managing the warehouse gives the financial institution better control on the

[121] Receivables discounting refers to the financing technique under which companies discount all or part of their receivables (represented by outstanding invoices) to a financer 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.

[122] OECD, New Approaches (supra, footnote 101), para. 92.

[123] M. Dubovek and A. Elias, A proposal for UNCITRAL to develop a Model Law on Warehouse receipts, 2017, p. 2, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3040742.

[124] There are two main types of warehouse arrangements, public and private. For the purposes of the draft Guide, it is important to note the following differences between them: (i) the different treatment of the commodities stored in the warehouse (in private warehouses the owner of the goods does not have to relinquish their possession to a third party); (ii) the requirement for a government license and to provide services to the public at large (public warehouses); and (iii) the supervision and regular inspections by government (e.g. ministries) or regulatory authorities (public warehouses). For a more detailed introduction to warehouse receipt financing, see M. Dubovek and A. Elias, A proposal for UNCITRAL (supra, footnote 123), p. 3.

[125] Ibid., p. 6.

[126] In countries where warrantage exists, it was noted that price seasonality was reduced and financial and planting decisions were also positively influenced. See International Food Policy Research Institute, Strengthening storage, credit and food security linkages – The role and potential impact of warehouse receipt systems in Malawi, 2015, p. 22.

transaction with the farmer. In addition, warrantage brings other benefits, for example since the goods deposited are not treated as fungible commodities, farmers can withdraw their own goods if their quality is at risk.

62. **Letters of credit** incorporate a commitment by a bank on behalf of the buyer that payment will be made to the seller, provided that the terms and conditions stated in the letters of credit are met. Most letters of credit are governed by the *Uniform Customs and Practice for Documentary Credits*, promulgated by the International Chamber of Commerce (ICC). While contributing to finance working capital, letters of credit are mainly used by businesses engaging in cross-border trade, subject to the distance between traders, the type of the goods traded and availability. For dynamic MSMEs, often medium-sized ones, integrated in global value chains as partners rather than mere suppliers of components and operating in emerging markets, letters of credit may be a more reliable tool than inter-company loans (e.g. factoring) since MSMEs do not have to employ costly or complicated risk management practices. However, letters of credit require very accurate documentation (e.g. bills of lading) concerning the underlying transaction, which may make them a particularly challenging instrument for those MSMEs without the necessary skills and experience to prepare such documents.[127]

63. The financing mechanisms described in the above paragraphs are usually covered by existing laws and regulations governing commercial contracts and dispute resolution, as well as any specific legal or regulatory framework concerning the operation of banks or a particular type of mechanism (for example, factoring). The challenges faced by MSMEs in their use vary according to the nature of the mechanisms; in general, they mainly relate to (i) lack of additional collateral, (ii) possible know-your-client concerns, (iii) requests for credit with insufficient information, (iv) requests not profitable enough to process, (v) complex or onerous legal requirements creating uncertainty as to enforcement of rights against local exporters, and (vi) requests not profitable to process due to regulatory capital constraints.[128] For financers, those challenges faced by MSMEs are the other side of the coin of challenges faced by them, such as low creditworthiness of some MSMEs and high transaction costs compared with the small amount of financing.[129]

C. Equity tools[130]

1. "Business angel" investment

64. "Business angel" investment[131] represents one main category of formal sources of private equity, which includes a broad range of external financing instruments, whereby enterprises obtain funds from private sources in exchange for an ownership interest.[132] Business angel investment is a valuable source of funds for MSMEs, especially those that are not yet ripe for VC funding.[133] Business angel investors[134] are usually actively involved in business management, and can offer business

[127] See OECD, Trade finance for SMEs in the digital era, 2021, p. 20.

[128] The Working Group may wish to note that the relevant report cited in this footnote only surveyed the challenges faced by small and medium-sized enterprises (SMEs). ADB, ADB Briefs No. 113, 2019 Trade Finance Gaps, Growth, and Jobs Survey, (2019), p. 5, figure 5.

[129] The secretariat has deleted section G on Corporate bonds of A/CN.9/WG.I/WP.126 as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 44).

[130] The secretariat has deleted the second part of this heading ("for MSMEs to access credit") as agreed by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 66).

[131] Business angel investment refers to investment made by wealthy individuals, or groups of them, who provide financing, typically their own funds, in exchange for ownership equity (sometimes also convertible debt).

[132] OECD, New Approaches (supra, footnote 101), para. 332.

[133] VC fund managers make direct investment in unlisted MSMEs, with the aim of bringing capital, technical and managerial expertise to raise the enterprise's value and make a profit at the exit (e.g. by selling the enterprise after some years). See Inter-agency Task Force on Financing for Development (supra, footnote 18), p. 67.

[134] Generally, the term "investors" refers to persons or entities who commit capital with the expectation of receiving financial returns.

expertise, access to a network and other non-financial benefits to enterprises they invest in (including MSMEs), which enable them to scale up to a stage where VC fund managers may step in.[135] It is difficult to estimate the size of business angel investments because such investors often stay anonymous and rarely disclose the details of their investments.[136]

65. Existing laws and regulations governing commercial contracts generally cover business angel investments, to the extent that investor's rights and obligations are set out in a contractual arrangement. They may also be subject to corporate law relating to corporate governance and other non-contractual issues. If the angel investor comes from a foreign country, such investment may also be subject to laws concerning foreign direct investment.

66. Financing from business angels can also come in the form of convertible debt which allows business angels to convert their loan into equity at a later date. MSMEs in their early stages may find this tool more attractive than equity financing since it permits to delay any change in the ownership structure of the business (which may immediately arise when the investment is in exchange for ownership equity). It also helps MSMEs to raise funds more quickly since it involves less negotiations and paperwork. Business angels may also consider convertible debt particularly valuable, as they receive interest on the loaned amount and in the event of the MSME default they may have a greater chance of debt recovery.[137]

67. Regardless of whether it comes in the form of debt or equity, business angel investment is rarely a guaranteed source of financing for all types of businesses, similar to family and friends support. Business angel investors typically invest in early-stage, innovative MSMEs.[138] Lack of tax incentives for business angel investments and lack of public co-investment funds which match public funds with those of business angel investors that are approved under the scheme may present challenges for business angle investors to invest in MSMEs in certain countries.[139]

2. Venture capital

68. As a form of private equity, Venture Capital (VC) is an important source of funds for MSMEs in countries with developed economies and economies in transition. VC fund managers make direct investment in unlisted MSMEs, with the aim of bringing capital, technical and managerial expertise to raise the enterprise's value and make a profit at the exit (e.g. by selling the enterprise after some years).[140] In addition to start-ups, VC fund managers also provide funding to an operating enterprise.[141]

69. Venture Capital investments are generally addressed in existing laws and regulations governing commercial contracts (to the extent that investor's rights and obligations are set out in a contractual arrangement) and corporate law (in the context of corporate governance and other non-contractual issues). If the VC fund manager comes from a foreign country, such investment may also be subject to laws concerning foreign direct investment. While VC investment could potentially narrow the financing gap for MSMEs, it is not suitable for all. VC fund managers are often interested only in a small group of MSMEs with (at least) a rapidly scalable business model.[142] Moreover, the exit environment (including the validity and enforceability of exit clauses), fundraising, high investee company valuations and the limited

[135] OECD, Financing SMEs and Entrepreneurs 2020 (supra, footnote 14), p. 43.
[136] European Investment Fund (supra, footnote 65), p. 32.
[137] The secretariat has added this short discussion on convertible business angels' financing consistent with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 68).
[138] OECD, Financing SMEs and Entrepreneurs 2020 (supra, footnote 14), p. 43.
[139] OECD, New Approaches (supra, footnote 101), para. 405.
[140] Inter-agency Task Force, Financing for Sustainable Development (supra, footnote 18), p. 67.
[141] European Investment Fund, (supra, footnote 65), p. 25.
[142] ITC, SME Competitiveness Outlook 2019 (supra, footnote 19), p. 25.

number of high-quality enterprises may result in the biggest challenges for the VC business in general, which also applies to the MSME sector.[143]

70. In certain countries, the underdevelopment of private equity markets constitutes the main challenge for the MSME financing sector to mobilize VC funds.[144] The lack of an enabling regulatory framework, training and industry data also discourages VC investments in other countries.[145]

71. It should be noted that in certain jurisdictions venture debt is also an important source of funds for early stage companies.[146] In its principal form, venture debt entails providing financing by way of two combined instruments: (i) a loan, which provides mid-term financing (normally repayable within five or six years) and which may be structured so the principal and part of the interest needs to be repaid only at maturity; and (ii) an incentive ("equity kicker") that allows venture debt providers to receive an equity ownership in the MSME. Such "equity kickers" can take various forms, including, without limitation, warrants, royalties, profit participation or convertibility options attached to the loan.

72. The debt element of the venture debt product is largely consistent throughout jurisdictions, whereas the "equity kicker" is particularly sensitive to local law specificities so its form and structure has to be adapted for the particular jurisdiction in question. It is considered a favourable financing tool by certain early stage businesses due to a lower dilution effect and also because venture debt providers do not get involved in the management of the business, as compared to simple direct equity investments.[147,148]

D. FinTech tools[149,150]

1. Introduction[151]

73. Rapid advances of digital technology in the last decade have resulted in new financial services and products (e.g. mobile money, online accounts, electronic payments, insurance and credit) as well as new business models that can facilitate MSMEs' access to credit in a faster, more convenient, and sometimes cheaper way than the traditional methods (although in some regions the high cost of Internet might actually result in an increased cost of credit). The COVID-19 pandemic has propelled an impressive acceleration in the use of those products given the need to access credit despite the difficulties posed by generalized lockdowns and curfews that resulted in

[143] EIF, EIF VC Survey 2019 – Fund managers' market sentiment and policy recommendations, 2019, p. iv.

[144] For instance, in Africa, about half of respondents to an industry survey cited the limited number of established private equity fund managers as a deterrent to investment. See Inter-agency Task Force on Financing for Development (supra, footnote 18), p. 67.

[145] ITC, SME Competitiveness Outlook 2019 (supra, footnote 19), p. 27.

[146] In Europe, it is estimated that venture debt represents about 3 per cent of the annual venture capital transactions in terms of amounts (with the European Investment Bank as the largest investor). In the United States, studies put this figure at about 15 per cent.

[147] The secretariat has added this short discussion on convertible forms of VC in keeping with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 68).

[148] As requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 70), the secretariat has removed the section on Public listing on stock exchanges from the draft Guide (paras. 123 and 124 of A/CN.9/WG.I/WP.126).

[149] The secretariat has added the chapter on FinTech tools as the last section of revised chapter III, as agreed by the Working Group at its thirty-seventh session (A/CN/9/1090, para. 71).

[150] The secretariat has deleted the opening paragraph of this section (para. 129 of A/CN.9/WG.I/WP.126) for improved readability.

[151] At its thirty-seventh session, the Working Group agreed that the introductory part on the section on Fintech should address digital financial services as a source of financing (A/CN.9/1090, para. 71). The secretariat has retained the opening paragraph (para. 130 of A/CN.9/WG.I/WP.126) without revisions as it is in line with the deliberations of the Working Group. However, the secretariat will improve consistency of the next three paragraphs (paras. 131 to 133 of A/CN.9/WG.I/WP.126) with the new introductory part of chapter III, in the next iteration of the draft Guide.

the closure of bank branches and, in many emerging economies, halted operations of mobile money agents. For women who tend to play roles both inside and outside of the home and have to face the resulting time constraints and those in some cultures whose movement outside home is limited and often dependent upon their husbands' approval, digital financial services are instrumental in improving access to credit for them, especially when geographical distance to markets and financial services is also a challenge.

74. As noted earlier (see para. 26), The delivery of these new digital financial products relies in particular on "new economy actors" such as mobile network operators (MNOs), financial technology (FinTech) firms, and large information and communication technology companies (BigTech) firms.[152] MNOs are large telecommunications service providers that are also licensed to offer e-money services through mobile phones and mobile telephone networks.[153] In a few countries, MNOs have developed digital credit products.[154]

75. FinTech firms 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 models.[155] 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, recent legislation places them under the supervision of the domestic financial market authorities.[156]

76. BigTech firms are large technology companies with dominant positions in the digital services market, such as online search engines, social media platforms, electronic commerce platforms, which also offer digital financial products and services. They often enter into the financial market once they have established a customer base and brand recognition and there is strong complementarity between the

[152] GPFI, Promoting digital and innovative SME financing (supra, footnote 27), p. 9.

[153] The first mobile money solutions were offered at the end of the year 2000 and dealt with money transfer and payments with MNOs acting as agents of the more traditional financial institutions.

[154] For example, in Kenya Safaricom has developed M-Shwari a savings and loan service that enables customers to open and operate an M-Shwari bank account through their mobile phone. To qualify for a loan, applicants must have subscribed to Safaricom for at least 6 months, save on M-Shwari and actively use other Safaricom services such as voice, data and its e-money service M-PESA. Loan limits range from Ksh.100 and to Ksh.50,000, with a standard one month (30 day) repayment period. Only one loan is allowed at a time. Loan repayment can be made via M-PESA, or from the M-Shwari account. A loan facilitation fee of 7.5 per cent is charged on micro credit (loan) products. In Ghana, MTN Qwik loan is one of the most common MNO's money loan service. It's a short-term, unsecured cash loan paid to the subscribers of the MTN Mobile Money wallet. For further information see https://mfidie.com/get-mobile-money-loans-ghana-fast/.

[155] While the first generation of FinTechs focused on making the traditional banks' offerings digitally available, unique products and services have emerged over time, such as points of sale finance or small ticket loans. Point of sale finance allows users to quickly finance large purchases with interest-free loans, instead of credit cards, which are set up at the point of sale. Advances in technology make point of sale finance cheaply available to small businesses. For example, Blispay does not charge businesses interest if they repay loans within six months, with the fee rising to 19.99 per cent after that. See www.aseantoday.com/2019/03/point-of-sale-finance-the-next-big-thing-in-FinTech-development/. The small ticket loan model created by FinTech firms allows to delivering buy mechanisms (like buy now & pay later) and one-click buy buttons on electronic commerce websites that make customers buy quickly without applying any authentication or using any card details. This model allows making money by sharing customer data with the original equipment manufacturer. See FinTech business models – UppLabs FinTech development.

[156] Finanzmarktaufsicht Österreich (FMA), Was ist FinTech?, retrieved from www.fma.gv.at/kontaktstelle-FinTech-sandbox/FinTechnavigator/was-ist-FinTech/http://www.fma.gv.at/kontaktstelle-FinTech-sandbox/FinTechnavigator/was-ist-FinTech/.http://undocs.org/at/kontaktstelle-FinTech-sandbox/FinTechnavigator/was-ist-FinTechwww.fma.gv.at/kontaktstelle-FinTech-sandbox/FinTechnavigator/was-ist-FinTech/.

financial services they provide, their core non-financial activities, and the associated economies of scope and scale.[157,158]

(i) Use of distributed ledger technology[159]

77. In recent years, several FinTechs, have increasingly relied on the use of distributed ledger technology (DLT)[160] for providing their financial services. DLT may be formulated in terms of a bundle of technologies and methods that are deployed to implement and maintain a ledger (or database) that is shared, replicated and synchronized on multiple networked computers (or servers). For example, FinTechs have developed software especially designed for factoring, allowing applications to be processed online automatically and payment to be made instantly.[161] FinTech software for factoring may increasingly include the use of blockchain technology (e.g. smart contracts) which could help eliminate multiple intermediaries, paperwork, fees, and inefficient process, and also prevent fraud, as every participant in the system can ascertain the existence of a factoring contract and each stage of the transaction.[162] DLT-based models have also been developed for warehouse receipts systems and implemented in several industries such as agriculture and petrochemical industries.[163] The use of DLT (such as blockchain technology) could also be explored in order to ensuring data quality in credit reporting systems, given that DLT has several inherent features that align well with the requirements for security and integrity of stored data.[164]

(ii) A legislative framework supportive of FinTechs tools for MSME access to credit[165]

78. A legislative framework supportive of FinTech products is mainly founded on regulatory measures or laws other than commercial law. For example, data protection laws address the duty of the platform to protect data of its users is addressed in data protection laws; general banking laws deal with "know your customers" obligations; and AML/CFT laws may apply to platform's operators fraud. Commercial or contract laws that are relevant in this context primarily include laws that ensure the formation, validity and enforcement of contracts concluded through technological means.

79. It is thus important for a country to have in place a legal framework that establishes the functional and legal equivalence of electronic and paper-based documents, ensure the legal validity of electronic signatures and electronic records and address issues such as authentication, time and place of dispatch and receipt of electronic messages. In this respect, UNCITRAL legislative texts on electronic data

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[157] BIS Annual Economic Report 2019, p. 61.

[158] The secretariat has deleted the last sentence of the paragraph (para. 133 of A/CN.9/WG.I/WP.126) since the discussion on electronic commerce platforms has been moved at the beginning of chapter III.

[159] The secretariat has shortened the sub-section on distributed ledger technology (paras. 146 to 149 of A/CN.9/WG.I/WP.126) and moved it to the introductory part of this Section C on FinTech tools as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 72).

[160] Reference to DLT in this text is not intended to recommend the use of this particular technology, but rather describes the existing and potential application of such technologies to topics related to access to credit for MSMEs. Any reform efforts should not inadvertently exclude the adoption of emerging technologies that might further improve access to credit for MSMEs.

[161] World Economic Forum (supra, footnote 85), p. 20. For a definition of "FinTech" see A/CN.9/WG.I/WP.119, para. 55.

[162] Unidroit Factoring Model Law Working Group, Background Research Report for the First Session, Study LVIII A – W.G.1 – Doc. 3, available at: www.unidroit.org/english/documents/2020/study58a/wg01/s-58a-wg-01-03-rev01-e.pdf.

[163] Unidroit Working Group on a Model Law on Warehouse Receipts, Background Research Report for the First Session, Study LXXXIII – W.G.1 – Doc. 4, paras. 53 to 55, available at: www.unidroit.org/english/documents/2020/study83/wg01/s-83-wg01-04-e.pdf.

[164] These features include (i) tamper resistance; (ii) a tamper-detection process of independent data verification; (iii) a distributed and redundant system architecture; and (iv) a network of heterogeneous nodes, Ibid., p. 17.

[165] In keeping with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 73), the secretariat has simplified this sub-section (paras. 150 to 155 of A/CN.9/WG.I/WP.126) and moved it to the introductory part of this section on FinTech tools.

transactions, digital identity and trust services can provide solutions appropriate to different legal traditions and countries at different levels of economic development.

80. For example, the *UNCITRAL Model Law on Electronic Commerce* (1996)[166] (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 and technology neutrality. [167] The *UNCITRAL Model Law on Electronic Signatures* (2001)[168] (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)[169] (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. Last but not least, the *UNCITRAL Model Law on the use and Cross-border Recognition of Identity Management and Trust Services* [170] addresses various obstacles to the broader use of identity management and trust services, including across borders.

81. Additional legal clarity may be needed for certain FinTech technological developments that introduce non-traditional contractual arrangements (for example, smart contracts [171] or robo-advisors [172]). Such new contracts 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.

82. Several countries established legally and regulatory protected environments (i.e. regulatory sandboxes) to test in a time-bound manner and under the control of regulatory authorities new products and services developed by FinTechs in order to determine whether they can be brought to the mass market. Sandboxes permit regulators to identify any associated risks with these innovations [173] and introduce new

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[166] See UNCITRAL Model Law on Electronic Commerce with Guide to Enactment 1996, with additional article 5 bis as adopted in 1998.

[167] 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.

[168] See UNCITRAL Model Law on Electronic Signatures with Guide to Enactment (2001).

[169] See UNCITRAL Model Law on Electronic Transferable Records (2017).

[170] UNCITRAL adopted the Model Law at its fifty-fifth session, in July 2022. At the date of this draft Guide, the latest version of the Model Law is contained in document A/CN.9/1113 which does not include the amendments agreed upon at the Commission session. The Model Law builds upon and complements existing UNCITRAL texts on electronic commerce, in particular their provisions dealing with electronic signatures. Trust is a fundamental element of trade and is particularly important online since electronic means allow transactions without prior personal interaction. Identity management aims to provide sufficient assurance of the online identification of physical and legal persons. Trust services aim to provide sufficient assurance of the quality of data, e.g. origin, integrity and point in time of transmission. The Model Law identifies the legal requirements to achieve that level of assurance and it sets a legislative standard not only for the use of electronic transactions and documents, but more generally for data exchanges.

[171] For a brief discussion on the different meanings of the term "smart contract", see A/CN.9/1012/Add.1, para. 24. 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: see World Bank, Smart Contract Technology and Financial Inclusion, 2020, p. 6.

[172] Robo-advisors are online platforms that use algorithms to automatically build and manage clients' portfolios.

[173] G. Cornelli, S. Doerr, L. Gambacorta and Q. Merrouche, BIS, Working Paper No. 901, Inside the regulatory sandbox: effects on fintech funding, 2020, p. 2.

laws or regulations, or enhance existing ones, to better address them.[174] Certain countries, for example, have enacted laws to facilitate the establishment of regulatory sandboxes as a key element of their domestic fintech system.[175] 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.[176,177]

2. Examples of selected FinTech tools for access to credit[178]

83. Digital products enabled by FinTech and the underlying business models cover a wide spectrum of financial services and are in constant evolution, the paragraphs below focus on three credit products that address basic needs of the businesses and are relatively simple to use. While they are appropriate for all MSMEs regardless of their stage of development, they may be particularly relevant for MSMEs in their initial stages.[179]

(a) Platform-based lending[180]

84. In platform-based lending, a web platform functions as an intermediary connecting MSMEs in need of capital with potential financers. Initially established as a niche market to connect individual borrowers and financers, platform-based lending has evolved into a great variety of business models. In many countries, the two most common types 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 investment finance by issuing securities. As it has been noted, the success of such platforms hinges on their ability to solve moral hazard issues and overcome significant barriers to entry related to adverse selection and funding cost advantage of regulated financial institutions.[181]

85. There are no global legal standards or policies governing those platforms and a growing number of countries are designing specific rules to make their operation more transparent, efficient and stable as well as mitigate risks for the users, both MSMEs and potential financers. For example, in October 2020, the European Union issued a regulation on crowdfunding service providers for business that for the first time sets forth uniform rules across the European Union for the provision of investment-based and lending-based crowdfunding services related to business financing. The Regulation establishes a harmonized framework for the protection of financers investing through the platforms which can also benefit MSMEs applying for loans and is based on: (i) clear rules on information disclosures for the MSMEs submitting project proposals and the crowdfunding platforms; (ii) rules on governance and risk

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[174] World Bank, Global Experiences from Regulatory Sandboxes, 2020, p. 2.

[175] See Mexico in World Bank, ibid. p. 20.

[176] G. Cornelli, S. Doerr, L. Gambacorta and Q. Merrouche, BIS, Working Paper No. 901 (supra, footnote 173), p. 2.

[177] The secretariat has added this paragraph on regulatory sandboxes in keeping with a suggestion of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 74).

[178] As requested by the Working Group at its thirty-seventh session (A/CN.9/1090, paras. 72 and 73), the secretariat has reorganized this subsection, also including a discussion on digital mobile credit. See also supra, footnotes 54 and 159.

[179] The secretariat has deleted the last sentence and amended the rest of the paragraph accordingly (para. 134 of A/CN.9/WG.I/WP.126) to ensure greater consistency with the revisions made in this subsection on examples of selected FinTech tools.

[180] At its thirty-seventh session, the Working Group agreed that the paragraphs on crowdfunding should further clarify the difference between lending crowdfunding (peer-to-peer lending) and investment-based crowdfunding (A/CN.9/1090, para. 72). To implement that decision, the secretariat has: (i) grouped peer-to-peer lending and investment-based lending under the heading "Platform-based lending"; and (ii) drafted a chapeau to introduce those two business models. In addition, the secretariat has included reference to the first regional standard on crowdfunding (EU Regulation 2020/1503).

[181] OECD (authored by O. Havrylchyk), Regulatory framework for the loan-based crowdfunding platforms, 2018, p. 3.

management for crowdfunding platforms; and (iii) strong and harmonized supervisory powers for national authorities overseeing the functioning of the platforms.[182]

(i) Lending crowdfunding (Peer-to-peer lending)

86. 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. Lending crowdfunding platforms can range from platforms where an individual lender act as direct lender for an individual loan to platforms where the lender can invest in pools or portfolios of loans indirectly.[183] Lenders may bid for the loans by offering an interest rate at which they would lend. Borrowers then accept loan offers at the lowest interest rate. Such flexibility with interest rates is one of the benefits for MSEs, another one is the possibility of obtaining loans of very small size that financial institutions may refuse to provide.

87. The platform can provide various services to assist matching lender(s) with the small business and facilitate the provision of the loan, for example it can assess information on the loan applicant, provide the contractual framework for the loan contract and setting loan pricing. It can also ensure loan servicing and collect lenders' funds for disbursement to borrowers, repayments from borrowers to lenders and deal with loan defaults.[184] Characteristics of lending crowdfunding platforms may vary significantly internationally and within domestic markets and due to the variety of offerings and business models there can be overlaps between those platforms and investment-based crowdfunding platforms offering debt-based crowdfunding (see paras. 83 and 84).

88. Lending crowdfunding is generally regulated by existing commercial laws and regulations governing electronic contracts and dispute resolution, as well as specific regulatory measures (in particular, those concerning peer-to-peer lending platforms). The growth of lending crowdfunding platforms in recent years[185] has increased the need to ensure protection of the platforms' users, both financers 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. inability of the platform) to management related risks (e.g. misconduct, negligence and in certain cases even fraud by the platform operators, or insolvency of the platform operator), 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).

(ii) Investment-based crowdfunding

89. Crowdfunding refers to a technique aimed at raising external finance from a large audience (often known as the "crowd"), rather than a small group of specialized investors, where each individual provides a small amount of the funding requested. Crowdfunding is typically offered through a FinTech platform model which connects investors with MSMEs wishing to borrow money by issuing debt or equity. The platform usually allows applications to be completed within a few hours,[186] which is

[182] See Regulation (EU) 2020/1503 of the European Parliament and of the Council of 7 October 2020 on European crowdfunding service providers for business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937 (Text with EEA relevance) available at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32020R1503.

[183] See World Bank, Policy Research Paper on "Consumer Risks in FinTech – New Manifestations of Consumer Risks and Emerging Regulatory Approaches", 2021, p. 74.

[184] Ibid., FinTech.

[185] Ibid., According to the World Bank, in 2018, peer-to peer lending represented the largest online alternative finance model by market segmentation, facilitating 64 per cent of the total global volume for the alternative finance industry.

[186] World Economic Forum (supra, footnote 85), p. 13.

one of the reasons crowdfunding has gained popularity among MSMEs in many countries.[187] Crowdfunding comprises different kinds of activities, broadly organized in three categories (debt-based, equity-based and non-investment). The term "investment-based crowdfunding" refers to debt-based and equity-based crowdfunding.[188,189]

90. Given its design and due to regulatory limitations, crowdfunding is suitable for MSMEs (in particular MSEs) at their initial stages that require relatively small amounts of funding. It may be less suitable for MSMEs based on complex innovations in very high-tech and cutting-edge areas requiring specific knowledge on the side of investors. It can be very costly to convince people to participate in crowdfunding, especially through cutting-edge communications and outreach involving pitches and social media.[190] Institutional investors are unlikely to use online platforms and may still prefer in-person meetings for the extensive information exchange necessary for them to feel comfortable with providing large loans.[191]

91. Existing laws and regulations governing electronic contracts and dispute resolution usually apply to crowdfunding activities. As crowdfunding is usually exempted from the application of traditional capital markets rules (e.g. publishing a prospectus, obtaining necessary authorizations, complying with reporting and corporate-governance requirements), certain limitations and thresholds are introduced in many jurisdictions to regulate the activities of issuers, platform operators and investors.[192] In order to develop enabling rules for crowdfunding, regulators generally have introduced or are in the process of introducing a specific crowdfunding exemption in the existing capital markets regulatory framework or a customized stand-alone crowdfunding regulation.[193]

92. MSME borrowers 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, issues concerning data security and the use of crowdfunding for illicit activities may pose additional legal risks.[194] Thirdly, the lack of a specific legal and regulatory framework for crowdfunding specifying the legal nature of crowdfunding and the default legal regime applicable to it does not help improve the business environment for crowdfunding.[195] In order for MSMEs to attract funds and facilitate

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[187] ITC statistics suggest that crowdfunding has grown rapidly (from $1 billion in 2011 to $34 billion in 2015), notably in Asia and Africa. Although the crowdfunding market in low income countries is estimated to total $96 billion per year by 2025, online debt-based crowdfunding activities continue to be strongly concentrated in a few countries. Relatively large crowdfunding markets exist in the United States (20.5 per cent) and the United Kingdom (7.5 per cent). Notably, the share of volumes in continental Europe remained relatively modest, with France the most active market (with a global share of 0.6 per cent), followed by Italy (0.6 per cent) and the Netherlands (0.5 per cent). Latin America accounted for a small share of global online alternative finance volumes: Peru (0.4 per cent) and Chile (0.2 per cent). OECD, Financing SMEs and Entrepreneurs 2020 (supra, footnote 14), p. 47.

[188] Debt-based activities in 2018 accounted for a very significant portion (96.4 per cent) of online crowdfunding volumes globally. See OECD, Financing SMEs and Entrepreneurs 2020 (supra, footnote 14), p. 45.

[189] The secretariat has revised this paragraph (para. 138 of A/CN.9/WG.I/WP.126) for improved clarity.

[190] World Bank, Crowdfunding in Emerging Markets: Lessons from East African Start-ups, (2015), p. 3. According to ITC, roughly two out of three crowdfunding campaigns failed to raise the target investment. See ITC, SME Competitiveness Outlook 2019 (supra, footnote 19), p. 78. The secretariat has moved this reference to ITC's figures to this footnote in order to limit time-bound references in the main text.

[191] ITC, SME Competitiveness Outlook 2019 (footnote 19), p. 78.

[192] World Bank, Policy Research Paper on "Consumer Risks in FinTech" (supra, footnote 183), p. 107.

[193] For example, Australia, Brazil, the European Union, Mexico, Nigeria, the United States and the Russian Federation. Ibid., p. 107.

[194] European Commission report on "Inception impact assessment: Legislative proposal for an EU framework on crowd and peer to peer finance" (October 2017), p. 2.

[195] Information for Development Program and World Bank, Crowdfunding's Potential for the Developing World, 2013; available at https://openknowledge.worldbank.org/handle/10986/17626.

crowdfunding, it is crucial to adopt legislation protecting investors (e.g. investment caps, and reflection periods during which contributors may revoke their offers, disclosure, due diligence, conflict of interest, insurance and reporting requirements for platform operators, as well as complaints handling procedures).[196] Notably, several domestic markets[197] ceased operations or shrank significantly due to concerns about dubious or outright fraudulent behaviour and insufficient guarantees in terms of capital requirements and loss provisions for investors.[198] It is worth noting that, while the lack of crowdfunding regulation can leave investors and MSME borrowers unprotected, excessive regulation can make implementation of the crowdfunding platform difficult.

93. The use of Islamic FinTech (including crowdfunding) has gradually gained popularity in a number of jurisdictions.[199] As discussed earlier (see para. 24), Islamic financial products in the market can be divided into two broad categories: asset-based and equity-based financial products (e.g. *Murabaha*, *Musharaka* and *Diminishing Musharaka*). One example of debt-based Islamic crowdfunding is a platform that finances the purchase of solar home systems – the *Murabaha* model, under which the financer 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.[200] This is also the model offered by most crowdfunding platforms in the market.[201] Equity-based financing (such as the *Musharaka* and *Diminishing Musharaka* models) can also be facilitated through Islamic crowdfunding platforms. In addition, non-investment models are largely suitable for Islamic crowdfunding given that interest rate is not charged.

(b) Digital mobile credit

94. Since the early 2010s, mobile money has emerged has a key means to obtain financial services, particularly in low income countries where the population often has easier access to mobile phones than to the Internet. Very rapidly, the use of mobile phones has expanded from basic services such as sending home money to more advanced transactions for example deposits, insurance or credit. The notion of mobile credit has also evolved from a "service which is available on basic mobile devices, and allows customers to borrow an unsecured loan and repay within a specific timeframe via mobile money"[202] to include mobile applications that allow access to digital credit.[203] Digital credit, which is also accessible via Internet connection,[204] can be provided in various ways which are usually grouped under two main models: (i) the mobile network operators (MNOs) partner with a licensed financial entity (e.g. a bank); or (ii) the MNO is a channel for the provision of credit. In the former instance, MNOs have broader responsibilities that may include, among others, data protection and regulatory compliance, while in the latter instance their responsibility is mainly limited to the distribution network.[205]

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[196] As examples of legislation concerning investment platforms and their use, see Russian Federation – Federal Law No. 259-FZ of 2 August 2019; Regulation (EU) 2020/1503 of the European Parliament and of the Council of 7 October 2020 on European crowdfunding service providers for business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937.

[197] For example, China and the Republic of Korea.

[198] In China, as of November 2020, all peer-to-peer lending platforms ceased operations. The market in the Republic of Korea, another relatively developed market, also plummeted by 77 per cent in 2018. See OECD, Financing SMEs and Entrepreneurs 2020 (supra, footnote 14), pp. 46–47.

[199] Indonesia, the United States, the United Arab Emirates, the United Kingdom and Malaysia. See IBRD, Leveraging Islamic FinTech to Improve Financial Inclusion (2020), p. 27.

[200] Islamic Development Bank, The Road to the SDCs – The President's Five-Year Programme: Progress and Achievements, pp. 50–51.

[201] For example, Ethis Group (Malaysia), Kapital Boost (Singapore) and Beehive (United Arab Emirates).

[202] GSMA, Mobile Insurance, Savings & Credit Report, 2015, p. 24.

[203] GSMA, Digital credit for mobile money providers, 2019, p. 4.

[204] Ibid., p. 5.

[205] Ibid., p. 6.

95. Digital credit has been described as "instant, automated and remote"[206] with reference to the manner in which it is provided. These three features differentiate it from conventional loans and make it very convenient for small businesses. Loans are small, short-term and quickly accessible: a loan decision can be made as quickly as within 24 hours. One reason for such quick turnaround is that the decision-making process is mainly automated and determined by computerized decision tree algorithms which also leverage non-alternative financial data (see paras. 220 to 222), such as mobile phones records, age of the applicant, social media and utility payment data. The use of non-alternative data permits small businesses borrowing for the first time, often MSEs, and without a credit history to access credit more easily. MSE eligibility for a loan is usually not subject to previous financial account ownership, however it is often tied to a preceding subscription and active use of the MNO's telecommunication services (usually for a minimum defined period of time).[207]

96. Easy access to digital credit is also possible because of the limited in-person interactions between the MNO and the MSE, as most transactions, e.g. loan application, disbursement and repayment, are carried out remotely, mainly via mobile phones. MNOs' call centres prompt borrowers to repay their loan by SMS and phone calls and also engage in exchanges with non-complying borrowers. This permits MSEs in remote locations to avoid difficult and expensive trips to municipal areas in order to visit financial institutions.[208]

97. Although digital credit can benefit MSEs in several ways, it may also expose them to risks for which they are unprepared. For example, digital credit has often higher interest rates than conventional loans; its terms and conditions may lack transparency on key aspects such as annualized rates of interest, incidental costs and fees or repayment schedules; and inappropriate use of alternative data may infringe upon data protection and privacy. Easy accessibility to credit may also result in MSE over-indebtedness since they may take out multiple loans from different providers at the same time. Unexperienced MSEs may not be able to sustain that much debt and may thus face aggressive debt-collection practices or enter a debt circle from which they cannot escape where one loan is used to pay off another. In order to address these and other risks (such as fraud or identity theft by providers operating from another jurisdiction), countries have begun to adapt their existing laws and regulations to the digital environment with the aim to promote digital credit, while ensuring improved user protection.

IV. Measures to facilitate MSME access to credit[209]

98. Chapters II and III discuss various obstacles that MSMEs face when accessing credit. While a few of them are generally not MSME-specific, MSMEs are more vulnerable economically, more dependent on certain types of financing (e.g. family and friends support) and may be less aware of their rights and obligations compared with larger enterprises. Moreover, the low accessibility of certain financial products in some jurisdictions (e.g. commercial credit) has also a negative impact on the prospect for some MSMEs to access affordable credit. As already noted, there are also a number of obstacles that are specific to MSMEs, such as lack of credit history, lack

[206] See CGAP Four Common Features of Emerging Digital Credit Offerings, 2016, available at https://www.cgap.org/blog/four-common-features-emerging-digital-credit-offerings.

[207] E.g. Kenya based Safaricom telecommunication provider requires potential borrowers seeking loans through its M-Shwari programme (i.e. a bank account offered in partnership with Commercial Bank of Africa) to be registered users of its mobile banking service Safaricom M-Pesa for at least six months. In Tanzania, the digital credit product Timiza, offered by Airtel and Jumo (a non-bank financial institution), is available only to existing Airtel customers holding an active Airtel Money account. See CGAP, Brief, The Proliferation of Digital Credit Deployments, 2016, p. 1, available at https://www.cgap.org/research/publication/proliferation-digital-credit-deployments.

[208] Ibid., p. 3.

[209] The secretariat has adjusted the title of this chapter as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 29).

of the expertise and skills needed to produce adequate financial statements, lack of collateral and limited financial or formal education. Many of these obstacles cannot be addressed by legal measures alone, and therefore States need to take into account regulatory and policy measures when necessary (see paras. 11 and 12). This chapter looks into some of those legal, regulatory and policy interventions that create the infrastructure through which MSMEs can access credit.

A. A legislative framework supportive of debt tools to enhance MSME access to credit[210]

99. As illustrated earlier, financers tend to impose collateral or guarantee requirements on MSMEs applying for credit (including, but not limited to, commercial credit, trade finance, and microcredit), which give financers some comfort in light of the low creditworthiness of some MSMEs. Collateral or guarantee are credit enhancement tools which can be used for any type of debt. Generally, an enhanced legal framework for the use of collateral (using both movable and immovable assets as collateral) and issuance of personal guarantees could provide more certainty and help more MSMEs satisfy those collateral or guarantee requirements. This section discusses a number of suggested improvements to existing legal systems concerning the use of collateral and the issuance of personal guarantees through highlighting relevant existing international standards (if any) and identifying possible areas for future improvements.

1. Existing international standards

(a) Movable assets as collateral

100. A credit transaction is categorized as "secured" when the borrower offers the lender assets as a guarantee of repayment of the sum it has borrowed. The assets that guarantee the debtor's obligation can be movable or immovable, tangible or intangible, and are known as "collateral". Over the years, UNCITRAL has produced a number of legislative texts dealing with the use of movable assets as collateral.[211] As noted in the *UNCITRAL Legislative Guide on Secured Transactions*, secured credit allows businesses to use the value inherent in their movable assets as a means of reducing the creditor's risk, because credit secured by assets gives creditors access to the assets as another source of recovery in the event of non-payment of the secured obligation.[212] In light of a reduced risk, creditors are more likely to be willing to extend affordable credit.

101. The paragraphs below discuss (i) the criteria for a secured transaction regime that facilitates credit for MSMEs and (ii) key features of an efficient registry system, drawn from the recommendations and guidance provided in the UNCITRAL legislative texts concerning secured transactions.

(i) Criteria for a secured transaction regime that facilitates credit for MSMEs

102. Movable assets may be the only type of asset that some MSMEs can offer as collateral. Some legal systems allow businesses to grant a security right in movable

[210] The secretariat has moved the section on a legislative framework supportive of debt tools for MSME access to credit (section H of chapter III in A/CN.9/WG.I/WP.126) under this revised chapter IV as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 33).

[211] According to information received from the secretariat, in the few years since its adoption, legislation based on, or taking the same approach as, the Model Law has already been adopted in nine States (Australia, Colombia, Fiji, Kenya, New Zealand, Nigeria, Papua New Guinea, Philippines and Zimbabwe). See A/CN.9/1097 and https://uncitral.un.org/en/texts/securityinterests/modellaw/secured_transactions/status. Other States that may have enacted laws based on the Model Law and participate in the deliberations of Working Group I may wish to provide that information to secretariat. The secretariat has added reference to the status of the Model Law as suggested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 45).

[212] UNCITRAL Legislative Guide on Secured Transactions (supra, footnote 102), p. 2.

assets only to a limited extent. Even where a legal system allows movable assets to be used as collateral, the rules may be outdated, fragmentary, complex or unclear for the persons who manage and operate MSMEs. Similarly, creditors may be hesitant to provide secured credit to MSMEs because of this lack of certainty.

103. Readily available credit at a reasonable cost helps MSMEs grow and prosper. Therefore, a secured transaction regime – that makes it possible and easy to use movable assets as collateral in such a way that lenders can determine their priority with respect to those assets when entering into the transaction and can be assured that realizing the collateral will be simple and economically efficient – would greatly assist MSMEs. The key features of a secured transaction regime that facilitates credit for MSMEs are the easiness it allows for: (a) creating security rights; (b) enforcing those rights; and (c) assessing the ranking of claims.

104. Firstly, it should be easy to create security rights over movable assets. As indicated in the *UNCITRAL Model Law on Secured Transactions* (the "Model Law"), the parties only need to enter into a security agreement that satisfies the simple requirements of the Model Law. Registration should not be a requirement for the creation of a security right. A person should also be able to grant a security right in an asset without having to give possession of the asset to the secured creditor.[213] A security right created in this way in an asset should be effective against the grantor and should extend to identifiable proceeds of the asset. For example, if an encumbered asset is sold, the security right should automatically extend to what is received as a result of the sale unless otherwise agreed by the parties.[214] Sample security agreements are provided in the *UNCITRAL Practice Guide to the Model Law on Secured Transactions* (the "Practice Guide").

105. As regards the types of movable assets which can be used as collateral, it should be possible for an MSME (acting as "grantor") to grant a security right in almost any type of movable asset, including inventory, equipment, receivables, bank accounts, intellectual property and digital assets. Allowing granting a security right in receivables may be particularly beneficial for MSMEs with very little assets. While in most cases, the MSME grantor will be the owner of the asset, a person with a limited right in an asset should also be able to grant a security right in that limited right even though that person is not the owner of the asset, for example, a security right may be granted in the right to use an asset under a lease agreement.[215] The MSME may also grant a security right in an asset that it may acquire in the future, as well as all of its movable assets. In order to simplify the creation of a security right in all assets of an MSME where the financer is financing its ongoing operation, it suffices to conclude a single-document and all-asset security agreement should be permitted.[216]

106. Secondly, it should be easy to enforce security rights over movable assets. Generally, a secured creditor should be provided different options to enforce its security right, such as selling the encumbered asset and recover what it is owed from the proceeds, leasing or licensing the encumbered asset and recovering what it is owed from the rent or royalty payments, and acquiring the encumbered asset in total or partial satisfaction of the amount due.[217] A secured creditor does not have to go to court and can instead enforce the security right itself. Out-of-court enforcement can make it possible for a secured creditor to recover what it is owed more quickly and more efficiently.[218]

107. Thirdly, it should also be easy to assess the ranking of claims. The most critical issue for a creditor that is considering extending credit secured by particular assets is

[213] UNCITRAL Practice Guide to the Model Law on Secured Transactions, para. 11.
[214] Ibid., para. 12.
[215] Ibid., paras. 35 and 36. For a lease that does not function as security right, please refer to the Unidroit Model Law on Leasing, 2008.
[216] UNCITRAL Legislative Guide on Secured Transactions (supra, footnote 102), p. 81.
[217] UNCITRAL Practice Guide (supra, footnote 213), para. 305.
[218] Ibid., para. 304.

what the priority of its security right will be in the event the creditor seeks to enforce the security right either within or outside the grantor's insolvency proceedings.[219] A secured transaction regime that facilitates credit for MSMEs should include clear priority rules that lead to predictable outcomes in any competition between claimants to the encumbered assets.[220] For example, as a general rule, as between security rights that were made effective against third parties by registration of a notice, priority should be determined by the order of registration, regardless of the order of creation of the security rights.[221]

Recommendation 1[222]

The Law should:

(a) Enhance the availability of credit by allowing the creation of security rights in all types of movable assets; and

(b) Be based on existing international standards that provide for a modern and comprehensive secured transaction regime.

(ii) Key features of an efficient registry system[223]

108. A security right that is effective only against the grantor has little practical value. A secured creditor would want to ensure that its security right is also effective against third parties, by publicizing its existence. A registry system plays a key role in publicizing the existence of security rights, particularly non-possessory security rights that do not require the secured creditor to take possession of the assets and allow the grantor to continue to make use of the encumbered asset even after granting a security right. The existence of a comprehensive and central registry system facilitates such non-possessory transactions. In many jurisdictions, this is done through establishing a general security rights registry. It is important that such non-possessory security rights are properly registered. As a general rule, the time of registration constitutes the basis for determining the order of priority between a security right and the right of a competing claimant.[224] This priority rule provides financers with certainty, thus encouraging the granting of credit to MSMEs.

109. An efficient registry system should have a number of key features aimed at facilitating secured transactions and making it easier for MSMEs to gain access to credit.[225] Firstly, the legal and operational guidelines governing registry services, including registration and searching, should be simple, clear and certain from the

[219] UNCITRAL Legislative Guide on Secured Transactions (supra, footnote 102), p. 189.
[220] Ibid.
[221] Ibid., recommendation 76 (a).
[222] The secretariat has added this recommendation as agreed by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 45).
[223] In 2013, UNCITRAL adopted the UNCITRAL Guide on the Implementation of a Security Rights Registry (the Registry Guide) which builds on the UNCITRAL Legislative Guide on Secured Transactions and its Supplement on Security Rights in Intellectual Property. The Registry Guide addresses the legal, technological, administrative and operational issues relating to the establishment and functioning of a collateral registry for movable assets. It is difficult for the secretariat to estimate how many States have implemented the recommendations in the Guide to design or improve collateral registries. Chapter IV of the Model Law on Secured Transactions includes Model Registry Provisions, aligned with the Registry Guide, that are intended to take effect simultaneously with the enactment of the Model Law. Presumably, the nine States that have enacted legislation based on, or taking the same approach as, the Model Law, have also implemented the Model Registry Provisions, see footnote 8 of the Model Law. The secretariat has added this information on the status of jurisdictions that have adopted international standards on security rights registries in line with a suggestion of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 45).
[224] UNCITRAL Model Law on Secured Transactions: Guide to Enactment, para. 143.
[225] It should be noted that the *UNIDROIT Guide on Best Practices for Electronic Collateral Registries* also provides useful guidance to the designers and operators of electronic collateral registries, such as establishing a standard for accountability of registrars. See UNIDROIT Guide on Best Practices for Electronic Collateral Registries, p. 69.

perspective of all potential users.[226] Secondly, registry services, including registration and searching, should be designed to be as fast and inexpensive as possible, while also ensuring the security and searchability of the information in the registry record.[227] Thirdly, a "notice registration" system (rather than a "document registration" system) should be adopted, not requiring the underlying documentation to be registered or even tendered for scrutiny by registry staff.[228] Such "notice registration" system reduces transaction costs for registrants.[229]

110. A security rights registry should also be fully electronic, permitting information in registered notices to be stored in electronic form in a single database, so as to ensure that the registry record is centralized and consolidated.[230] Furthermore, 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.[231] 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.[232]

Recommendation 2[233]

The Law should establish an efficient registry for the registration of notices with respect to security right to enhance certainty and transparency in accordance with existing international standards.

(b) Immovable assets as collateral

111. While there are no global 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, a regional standard prepared by the European Bank for Reconstruction and Development (EBRD), can provide useful reference in respect of[234] (i) legalization of property rights over immovable assets and (ii) key features of an efficient legal framework.

(i) Legalization of property rights over immovable assets

112. Secured credit allows MSMEs to use the value inherent in their assets as a means of reducing the creditor's risk of not being paid, thus resulting in prospective creditors being more willing to extend credit to MSMEs. However, in order to be used effectively, in most countries rights over assets (including customary rights) need to be formally recognized by a property rights system. Once fully recognized, the possibility is opened for MSMEs to use assets as collateral for obtaining credit.[235] For

[226] UNCITRAL Guide on the Implementation of a Security Rights Registry, para. 10.
[227] Ibid.
[228] Ibid., para. 57.
[229] Ibid., para. 59.
[230] UNCITRAL, Guide to Enactment (supra, footnote 224), para. 145.
[231] Ibid., para. 146.
[232] Ibid. See also UNCITRAL Legislative Guide on Key Principles of a Business Registry (2019) and the work of Unidroit on best practices in the field of electronic registry design and operation.
[233] The secretariat has added this recommendation as agreed by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 45).
[234] The secretariat has clarified the absence of international standards on immovables and retained reference to the regional standard prepared by the EBRD as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 49). In this respect, the Working Group may wish to recall its deliberation at its thirty-seventh session not to include any legislative recommendation on the use of immovables as collateral in the draft Guide (A/CN.9/1090, para. 50).
[235] Commission on Legal Empowerment of the Poor, Making the Law Work for Everyone, Volume I, Report of the Commission on Legal Empowerment of the Poor (2008), pp. 6–7. The Commission was an independent international forum made up by policymakers and high level practitioners of countries in different regions of the world and hosted by the United Nations Development Programme (UNDP). Established in 2005, the Commission ceased to exist in 2008 after issuing

MSMEs with very few or no movable assets, the possibility of using immovable assets as collateral is particularly important as a means of gaining access to affordable credit.

113. However, in several countries businesses (including MSMEs) lack formal recognition of their property rights over immovable assets in both urban and rural areas. Lack of proper title or inefficient registration systems could make mortgages 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 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, financers may accept a simple certificate of customary interests and rights in land (rather than a formal ownership certificate) as collateral. Recent land reforms[236] for example, required the establishment of special agencies to keep accurate and up-to-date 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.[237]

114. According to the International Fund for Agricultural Development (IFAD), there are a variety of land tenure contexts across the world which are defined by policy and legal choices as well as by cultural, historical, religious and gender dynamics. In those contexts, there are many types of tenure security (defined by the customary nature of tenure and challenges relating to conflict resolution and the enforcement of rights) and some types are less lengthy and costly to implement, which may be even more effective than recording formal rights over land, such as "fit for purpose" land certification systems, recognition of community forest rights and community-based management of land.[238]

115. 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 declares that "States shall 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.[239]

(ii) Key features of an effective legal framework

116. 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 objectives of the *Model Law on Secured Transactions* to enable the use of movable assets as collateral can equally apply to a regime on immovable assets,[240] although the norms governing immovable assets have their own

its report "Making the Law Work for Everyone". Work on legal empowerment of disadvantaged people is carried on by UNDP.

[236] For example, Ghana.

[237] IFC, Research and Literature Review (supra, footnote 78), p. 9.

[238] G. Barbanente, H. Liversage, J. Agwe and M. Hamp, IFAD report on "Tenure Security and Access to Inclusive Rural Financial Services for Smallholder Farmers: Challenges and Opportunities in Rural Development Projects" (forthcoming), pp. 13–14 and 18.

[239] Commission on Legal Empowerment of the Poor, Making the Law Work for Everyone (supra, footnote 235), p. 7.

[240] 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).

specificities.[241] While in some countries the rules governing the creation, validity and enforcement of collaterals apply to both movable and immovable assets, some other countries have adopted a system[242] with specific types of security interest for specific assets. Arguably, the functional approach adopted by the *Model Law on Secured Transactions* can also be adapted to the context of immovable assets. Under this approach, an effective legal framework for secured transactions involving immovable assets should apply to all transactions under which a property right is created by agreement of parties to secure payment or other performance of an obligation, regardless of the form of transaction, the terms used by the parties to describe the transaction, or whether the assets are owned by the grantor or the secured creditor.

117. An effective secured transaction regime involving immovable assets should include the following three key features. First, it should be easy to create security rights over immovable assets. An efficient secured transactions regime should establish streamlined procedures for obtaining security rights over immovable assets. As listed in the EBRD Core Principles for a Mortgage Law, the law should enable the quick, cheap and simple creation of a proprietary security right without depriving the person giving the mortgage of the use of his/her property. Mortgage should be granted (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 as far as possible.[243] 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. Ease in creating a security right over immovables does not necessarily mean abolishing all formalities justified in the interest of legal certainty or extending to immovable collaterals the same rules applicable to movable ones.[244]

118. Secondly, it should be easy to enforce security rights over immovable assets. A security right will have little value to a secured creditor unless it can be enforced effectively and efficiently. An effective secured transactions regime should include procedures that precisely describe the rights and obligations of grantors and secured creditors upon enforcement. The law should provide for expeditious court enforcement at reasonable costs as enforcement costs will reduce the proceeds on realization. Consideration could also be given to allowing secured creditors to enforce their security rights out of court, subject to judicial or other official control, supervision or review of the enforcement process when appropriate. For mortgages, the EBRD Core Principles for a Mortgage Law provide that 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.[245]

119. Finally, it should be easy to assess the ranking of claims over immovable assets. A prospective creditor must not only be able to ascertain the rights of the grantor and third parties in the assets to be encumbered, it must also be able to determine with certainty, at the time it agrees to extend credit, the priority that its security right in encumbered assets would enjoy relative to the rights of other creditors (including an insolvency representative in the grantor's insolvency). The EBRD Core Principles for a Mortgage Law stipulate that the law should establish rules governing competing rights of persons holding mortgages and other persons claiming rights in the

[241] The secretariat has added this sentence consistent with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 49).

[242] The secretariat has deleted the phrase "more antiquated" before "system" as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 49).

[243] EBRD Core Principles for a Mortgage Law, Principles 2, 7 and 10.

[244] The secretariat has added this discussion on certain formalities to be preserved when simplifying regimes on immovable assets in in line with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 49).

[245] EBRD Core Principles for a Mortgage Law, Principle 4.

mortgaged property.[246] Priority should be determined according to the order of registration as opposed to the time of creation of a security right. 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.[247] 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 more simple and quick if registration is merely intended to publicize the mortgage claim.[248]

2. Possible areas for future improvement

(a) Use of collateral

Obstacles faced by MSEs and financers in the use of collateral[249]

120. While the Model Law is designed to improve access to credit and to lower the cost of credit for all kinds of businesses, it is particularly well suited for small and medium-sized enterprises. Its norms can also enable secured lending for microenterprises.[250] Despite the obvious advantages of the existence of a legal framework based on the Model Law, this by itself may not remove all of the obstacles that MSMEs may face in obtaining access to credit, in particular those faced by micro and small enterprises.

121. One of the main reasons MSEs strive to obtain credit is that banks and other financial institutions are usually reluctant to extend uncollateralized credit to them even at high interest rates, because credit assessment reveals high risk of default by those businesses. Collateral requirements are quite high worldwide for borrowers (including microenterprises)[251] and many MSEs do not have the necessary amount and/or type of assets that could serve as collateral. In certain jurisdictions this issue is particularly significant for women entrepreneurs as any asset or property is often owned or registered in the spouse's name. For example,[252] women do not have the right to administer marital property, including property that they brought into the marriage and property acquired during the marriage[253] which considerably limits their ability to offer collateral in order to access credit.

122. Household goods owned by MSEs are often not accepted as effective collateral given that they generally have low value and 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.[254] From the perspective of microlenders, these forms of collateral serve primarily to demonstrate the microenterprise's commitment, rather than as a secondary repayment source.[255]

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[246] Ibid., Principle 9.
[247] EDRB, Mortgages in transition economies – The legal framework for mortgages and mortgage securities, p. 21.
[248] Ibid., p. 22.
[249] In keeping with deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 57), the secretariat has revised this subsection as follows: (i) has identified the main problems arising in the use of collateral and possible solutions (A/CN.9/1090, para. 57); (ii) has nuanced the discussion on overcollateralization (A/CN.9/1090, para. 55); (iii) has clarified that determination of assets exempt from enforcement is a State decision; and (iv) has added reference to the Unidroit project on "Best Practices for Effective Enforcement" (A/CN.9/1090, para. 56).
[250] UNCITRAL Practice Guide (supra, footnote 213), para. 26.
[251] In Asia and the Pacific, financial regulations in many countries require collateral to be at least 125 per cent of loan value. See ADB, Thematic Evaluation: ADB Support for SMEs, (2017), p. 3, footnote 12. In other countries, collateral requirements are even higher and can be as high as 250 per cent of loan value. See IMF, Financial Inclusion (see footnote 49), p. 16. According to one ADB survey (2019), lack of collateral was cited as the top challenge for small and medium-sized enterprises to access trade finance. ADB, ADB Briefs No. 113 (supra, footnote 100), p. 5, figure 5.
[252] World Bank, Secured Transactions (supra, footnote 60), p. 22.
[253] Ibid.
[254] ILO, Making Microfinance Work (supra, footnote 66), p. 120.
[255] Ibid.

123. In order to tackle MSEs' lack of collateral, countries may adopt different measures in light of their policy needs. First, they can expand the pool of assets that MSEs can provide as collateral, for example, allowing the use of all types of movable assets as suggested in the *UNCITRAL Model Law on Secured Transactions* – the *Model Law* – (see arts. 1 and 8) and allowing such assets secure all types of obligations (see art. 7 of the Model Law). Second, countries may review their prudential regulatory framework imposing capital requirements on regulated financial institutions. Financial institutions are usually required to have a minimum amount of capital ("regulatory capital") any point in time in relation to their exposure to risks. In practice, for any financing transaction, e.g. a loan, a regulated financial institution calculates a capital charge that reflects the level of risks of that transaction (in particular credit risk).[256] Loans with higher levels of risks are subject to higher capital charges that can easily translate in higher collateral requirements for the borrower. MSEs' loans in particular often fall in this group of riskier transactions. Relaxing such requirements could make financial institutions more willing to lend to this segment of MSMEs and facilitate their access to credit. Of course, this may result in a high burden on financers that would assume all risks in case of loan default. For further clarity, it can be noted that allowing for security rights to be created in all types of movable assets and relaxing capital requirements are not mutually exclusive measures and could be implemented at the same time.

124. Yet another measure would be supporting the use of alternative sources of credit such as guarantee schemes, peer-to-peer lending or family and friends support and of enhanced tools to assess the MSE creditworthiness. Peer-to-peer lending and family and friends support might prove particularly useful to address the many instances where an MSE has no assets at all to offer as collateral, a circumstance that no legislative or regulatory reform can remedy.

125. Another obstacle MSEs often face in the access to secured credit is the difficulty of financers to determine the value of the collateral(s),[257] which provides the basis for making rational predictions as to how much can be realized from the collateral(s) in the event of default. The value assessment is a rather complex process despite the existence of certain standards.[258] It may become even more complex for MSEs' loans as the replacement value of certain assets (from the MSE perspective) may be much higher than the actual market value. In other cases, the value of some assets – such as manufacturing and industrial equipment, and agricultural products – can be affected not only by their condition but also by market situation and trends.[259] For example, equipment in good working condition may have little resale value if a more efficient model is available or market trends favour a newer design.[260] Sometimes it may be particularly difficult to determine the value of the asset if it is a type that is not regularly traded in the given market.[261] In addition, the absence of appropriate valuation methods or the fact that available methods are too costly relative to the value of the asset may also negatively affect the financers' ability to engage in a proper valuation of the collateral. One option might be for the States to increase the availability of independent appraisal mechanisms for the financers. Developing financers' expertise to perform reliable valuations of the assets to be encumbered and

[256] See UNCITRAL Practice Guide (supra, footnote 213), pp. 95–96.
[257] In practice, there are many ways to determine the value of the collateral assets and the chosen method often differs depending on the specific type of asset. For instance, if the assets are receivables, their value will usually be based on the amount that the financer would expect to collect from the debtors of the receivables. If the asset is inventory (e.g. clothing), its value will normally be calculated based on prices in the relevant secondary market. See UNCITRAL Practice Guide (supra, footnote 213), para. 121.
[258] See https://www.ivsc.org/standards/.
[259] World Bank, Secured Transactions (supra, footnote 60), p. 104.
[260] Ibid.
[261] UNCITRAL Practice Guide (supra, footnote 213), para. 123.

leaving valuation of the encumbered assets to them (rather than independent appraisers) seems to be a more efficient and less costly mechanism.[262]

126. Sometimes, financers require MSEs to provide collateral, the value of which significantly exceeds the amount of the loan (often referred to as "overcollateralization")[263] because they are not able to or bother to determine the appropriate value of the collateral. While the financer usually cannot claim more than the secured loan (plus interest and expenses), this practice of overcollateralization may limit businesses from utilizing the maximum value of their assets and obtaining secured credit from another financer using the residual value, both of which are facilitated under the *Model Law*. For example, the *Model Law* provides an option under which the State would require that the maximum amount for which the security right can be enforced is included in the security agreement (art. 6(3)(d)).

127. As noted by the World Bank, the existence of liquid secondary markets where the collateral provided by the MSE can be disposed of would permit financers to assess its value more accurately when determining how much credit to extend[264] and could thus reduce the risk of overcollateralization. This would be of critical importance to incentivize MSEs' secured lending, since the assets provided by those businesses are likely be tangible rather than intangible. As it has been said, if secondary markets do not exist, they can be created, mainly by the private sector but also by the State, in a creative way, for example online auctions.[265] It would also be important to establish some basic safeguards, for example the duty of good faith, to ensure that these markets operate in accordance with transparent pricing mechanisms. It should be noted, however that even when secondary markets exist the financer may not always be able to recover the current 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.[266]

128. The *UNCITRAL Legislative Guide on Secured Transactions* notes some approaches taken by courts in different jurisdictions to address over-collateralization, for example: (i) declaring void any security right that encumbers the value of an asset to an extent that is grossly in excess of the secured obligation plus interest, expenses and damages; (ii) giving the grantor a claim for release of such excess security; and (iii) upon the grantor's request, requiring the secured creditor to negotiate in good faith with the grantor.[267] The *Legislative Guide* further notes that States could address the issue in different ways, including in other areas of law and for this reason does not recommend that courts be given the authority to declare a security right void or to reduce the scope of a security right by means of a judicial declaration of overcollateralization.[268]

129. Finally, another major challenge in extending secured credit (but this also applies to unsecured credit) to MSEs is the inadequacy of available enforcement mechanisms in relation to recoverable amounts, which makes it difficult for a financer to recover what it is owed from the value of the collateral. Effective and cost-efficient legal enforcement mechanisms support credit provision. Conversely, cumbersome enforcement processes may discourage financers from lending to MSEs. For example, the financer may be required to bring a court action 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.[269] On the other hand, availability of effective and cost-efficient

[262] UNCITRAL Legislative Guide on Secured Transactions (supra, footnote 102), chapter VIII, para. 70.
[263] In practice, overcollateralization may be in combination with requests for issuance of personal guarantees (see chapter IV, section 1 (b) on personal guarantees for MSEs' loans).
[264] World Bank, Secured Transactions (supra, footnote 60), p. 40.
[265] L. Gullifer, I. Tirado, A global tug of war: a topography of micro-business financing, in law and contemporary problems, No. 1, 2018, p. 130.
[266] UNCITRAL Practice Guide (supra, footnote 213), para. 122.
[267] UNCITRAL Legislative Guide on Secured Transactions (supra, footnote 102), p. 82.
[268] Ibid., pp. 82–83.
[269] UNCITRAL Legislative Guide on Secured Transactions (supra, footnote 102), p. 275 (para. 1), English edition.

enforcement mechanisms, including out-of-court enforcement, as provided in the *Model Law* is likely to encourage financers to lend based on MSEs' assets. While out of court enforcement may be more advantageous for financers, it may however pose risks of misuse. To minimize any such risks, the Model Law imposes conditions on how financers can undertake out of court enforcement (Model Law arts. 77–80).[270]

130. It should be noted that laws other than the secured transaction law could impact a financer's enforcement options. For example, certain laws may restrict the creation of security rights in household goods, the seizure of personal assets, or may limit the amount for which a security right in those assets can be enforced. Whether certain assets (e.g. essential personal assets, household goods) should be exempt from enforcement is a policy question for each individual State. However, financers should be aware of any such restrictions as it would affect their decision to lend.

131. As indicated earlier, inadequacy of available enforcement mechanisms also affects unsecured credit and other commercial claims. In recent years, the importance of having in place a sound domestic legal framework in relation to enforcement of commercial claims has prompted growing interest at the international and regional level. International projects are ongoing to draft guidance for domestic legislators on how to address enforcement related challenges.[271,272]

Note to the Working Group: *The Working Group may wish to consider formulating a recommendation to address the issues affecting the use of collateral for microenterprises as discussed above.*

(b) Personal guarantees for MSEs' loans

132. Personal guarantees can facilitate access to credit for MSMEs, since they reduce financers' risks in lending thus incentivizing them to extend credit to small businesses. Within the MSMEs' group, particularly micro and small enterprises may resort to personal guarantees to secure credit, hence the following paragraphs focus on this segment of MSMEs and consistently use the acronym MSE(s).[273]

133. Personal guarantees create an additional obligation by a third person (i.e. the guarantor) that is distinguishable from the main obligation of the MSE. The guarantor who can be the MSE owner, will repay the main obligation if the MSE fails to perform and will likely become subrogated to the financers' rights against the MSE including the right to enforce the loan. Guarantees are usually unsecured, meaning that they are not backed by any specific asset so if the guarantor cannot repay the main obligation, the financers may seize any of its private assets. Financers might request to secure

[270] See also UNCITRAL Practice Guide (supra, footnote 213), para. 304.

[271] Since 2020, Unidroit is carrying out work on "Best Practices for Effective Enforcement", with the aim to prepare an international instrument for national legislators which can assist them addressing issues of enforcement of commercial unsecured and secured debts. For further information, see https://www.unidroit.org/work-in-progress/enforcement-best-practices/#1644493658763-89df3b2e-4a80.

[272] For improved clarity of the draft Guide, the secretariat has deleted the discussion on "International instruments facilitating the use of certain movable assets as collaterals" (paras. 85 to 89 of A/CN.9/WG.I/WP.126) since its focus was on legislative projects not yet completed. Subject to its deliberations at its thirty-ninth session (Vienna, 19 to 23 September 2022), the Working Group may wish to consider whether the secretariat should replace that discussion with one on existing texts concerning certain movable assets as collaterals, in particular the Supplement on Security Rights in Intellectual Property to the UNCITRAL Legislative Guide on Secured Transactions (2010).

[273] In keeping with deliberations of the Working Group at its thirty-seventh session, the secretariat has revised the opening sentence of this paragraph (para. 90 of A/CN.9/WG.I/WP.126) to: (i) highlight the importance of personal guarantee in facilitating MSE access to credit (A/CN.9/1090, para. 58); and (ii) indicate that this part of the Guide may be less relevant for medium-sized enterprises (A/CN.9/1090, paras. 18 and 19).

the guarantees against specific assets of the guarantor, and in the event of performance failure they will seize those assets.[274]

134. While a request for personal guarantees may be more common when collateral assets are not available at the level required by the financers' risk assessment, so that the personal guarantees supplement the collateral's gap, financers may demand personal guarantees even when the collateral offered is commensurate with the risk they assume in order to further reduce it. Indeed the personal assets of the guarantor could be equal to or of greater value than those of the MSE, in particular if the MSE is a start-up.[275] Further, a personal guarantee provided by a family member (often the spouse) or a friend of the entrepreneur, may indicate to financers the entrepreneur's commitment to repay the debt given the strong personal ties with the guarantor.[276]

135. For MSEs, provision of personal guarantees may be the only way to obtain credit, if they lack adequate asset to offer as collateral or a solid credit history demonstrating their creditworthiness. Securing financing that would otherwise be out of reach for many of them may help MSEs to establish a position in the market and eventually grow. Very often, the alternative may be not getting credit at all because the risk of loss from default would be too large for the financer to accept it. Even when the MSE is well established and can offer collateral to secure a loan, provision of a personal guarantee can reduce the need to offer business assets as collateral and result in a considerable improvement of the loan conditions, for example a lower interest rate, a larger loan amount or a longer payoff term. This can support MSE's competitiveness on the market and further improve it. Moreover, in countries with weak secured transaction regimes, personal guarantees provide for an effective alternative to asset-based lending. In addition to supporting a loan request, in certain cases MSEs may provide a personal guarantee to another MSE in order to guarantee the payment of debt owed to that business for the supply of goods or services.[277]

136. Efficient personal guarantee regimes should not replace financers' lack of appropriate tools to carry out a proper credit risk analysis and should always balance financers' rights to recover their credit with adequate protection of the guarantor. In particular, it is important that norms are in place to protect vulnerable guarantors for example, family members or friends of the entrepreneur who may grant a personal guarantee against their better judgment or under an emotional state (see paras. 155 to 158), without full knowledge of the implications or of the MSE financial situation.[278]

(i) Dependent and independent personal guarantees

137. In many legal traditions, personal guarantees are grouped into two general categories depending on the link between the guarantee and the underlying contractual relationship.[279] Under the first category (independent guarantees), where the guarantee is independent from the underlying contractual relationship, the

[274] The secretariat has revised the last two sentences of the paragraph (para. 91 of A/CN.9/WG.I/WP.126) to clarify the difference between secured and unsecured personal guarantees in line with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 59).

[275] In certain countries, merchant cash advance is an alternative option to personal guarantees and collateral where the financer provides an upfront lump sum in exchange for a percentage of future credit and debit card transactions processed by the business. Approval is based on the current performance of the business. See www.smeloans.co.uk/blog/personal-guarantees-by-directors-the-ultimate-guide/.

[276] The secretariat has added a discussion on the benefits of personal guarantees provided by the MSE owners, their family members or friends as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 63).

[277] The secretariat has included a new paragraph to better highlight how personal guarantees facilitate access to credit (para. 92 of A/CN.9/WG.I/WP.126) in line with deliberation of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 58).

[278] Further to comments made by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 58), the secretariat has added reference to the importance of ensuring adequate legal protection to family members or friends of the entrepreneur acting as guarantors.

[279] M. Damjan, A. Vlahek, The protection of consumers as personal security providers under the DCFR and European Union consumer law, 2018, p. 21, available at: www.researchgate.net/.

guarantor is obliged to perform after receiving from the creditor a demand for performance that complies exactly with the terms set out in the contract or other juridical act creating the guarantee (standby letters of credit are usually considered an example of such independent guarantees).[280] Since the guarantee is independent from the obligation of the principal debtor, the guarantor cannot reject the demand for performance on the ground that the debtor's obligation is not yet due or the debtor has already settled it. The personal guarantor can only invoke its own defences against the creditor (e.g. a set-off objection when the personal guarantor has another claim against the creditor).[281]

138. Independent guarantees are largely used in international transactions since due to their independence from the underlying contract they are particularly effective in building the creditworthiness of the business with foreign creditors. Because of the considerable level of risk for the guarantor, they are often provided upon a fee by financial institutions that have the resources and the expertise to handle the risks of international transactions and a stronger bargaining position than an individual guarantor to negotiate more favourable terms (for example, a right to reverse their performance after their payment if the secured claim has been held invalid or unenforceable). [282] Within the MSMEs category, businesses using independent guarantees are often mature medium-sized enterprises active in cross-border transactions and with sufficient resources to pay for the additional cost of the guarantee. Due to the more limited resources and geographic range of transactions, MSEs mainly rely on dependent guarantees, usually known as suretyships. In many countries, independent guarantees are not specifically regulated by law and are mainly created through contract practice and subject to general principles of contract and commercial law, the *United Nations Convention on Independent Guarantees and Stand-by Letters of Credit* (New York, 1995), may thus assist States in developing a predictable and effective legal regime that applies to those guarantees.

139. Under the second category of guarantees (dependent guarantees or suretyships), where the guarantee is linked to the underlying contractual relationship, the guarantor's obligation is accessory to the debtor's main obligation and the guarantor acts as a secondary obligor for the principal debtor in case of default.[283] Therefore, the creditor may 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.[284]

140. As noted above (see para. 138), suretyships are preferably used by MSEs that, due to the nature of their activity, engage in less complex transactions at local level. They are usually provided by non-professional financers who are the owners, members of the MSEs, their family members or other related persons. The guarantees not only ensure that the business loan will be repaid in a timely manner, but also build trust between the financers and the MSEs, since they indicate to the financers that the MSE will be more likely to treat the repayment of the loan as a priority as their income or property (or that of individuals close to them or associated with the business) is at risk.[285]

141. In certain jurisdictions, there may be an additional type of personal guarantees that combine features of independent and dependent guarantees. For example, some countries have introduced guarantee instruments for natural persons acting in their

[280] See also the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 1995).
[281] M. Damjan, A. Vlahek, The protection of consumers (supra, footnote 279), p. 24.
[282] A. Schwartze, Personal Guarantees Between Commercial Law and Consumer Protection, in General Reports of the XIXth Congress of the International Academy of Comparative Law (M. Schauer, B. Verschraegen, eds.), 2017, p. 375.
[283] C. Henkel, Personal Guarantees and Sureties between Commercial Law and Consumers in the United States, The American Journal of Comparative Law, vol. 62, 2014, p. 337.
[284] M. Damjan, A. Vlahek, The protection of consumers (supra, footnote 279), p. 23.
[285] T. Wolff, Look before you sign… the pitfalls of personal guarantees, 2018, available at: The National Law Review (www.natlawreview.com/article/look-you-sign-pitfalls-personal-guaranties).

professional capacity, and businesses of all sizes and legal forms (i.e. with or without legal personality) which provide for greater contractual freedom. Parties can agree on the trigger events for payment, including in the absence of a payment default under the guaranteed debt; or have the ability to guarantee (current or future) specific payment obligations, a debt portfolio or only some risks associated with them to one or several existing or future beneficiaries; or determine the extent to which the guarantor can waive its rights for recourse (i.e. unless otherwise agreed, the guarantor cannot rely on any defences or exceptions under the guaranteed obligation to refuse or delay payment). Such instruments may also allow for references to the guaranteed obligation without the risk of being requalified as a suretyship.[286,287]

(ii) The relevance of dependent personal guarantees for MSEs

142. Although, issuing a personal guarantee for a business loan is common for many MSEs across different regions of the world,[288] personal guarantees may run counter the very purpose of statutory limitation of liability for incorporated MSEs. In practice, the MSE will have to forego the shield of limited liability for its members, since either the owner or another person who is closely related to the MSE will become personally liable for the MSE's debts. Moreover, the default of an MSE may cause dramatic financial problems for the guarantors[289] and their households and in some countries this may lead to strong social stigma. In certain countries, surety bonds may provide an alternative to guarantees even for small businesses, in particular if MSEs are engaged in certain commercial sectors (for example construction or public procurement). Surety bonds are usually issued by an insurer (the surety) and incorporate a promise that the insurer will pay to another party (the obligee or beneficiary) an agreed amount in the circumstances set out in the bond wording and in line with an underlying contract between the obligee and the principal debtor. Surety bonds have the same scope of the guarantees, but they do not require collateral, including cash collateral. This permits MSEs to enhance their working capital and liquidity to finance their activities. Moreover, surety bonds can help MSEs 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 MSEs than guarantees.[290] The experience in other countries indicates that they may not be appropriate for such small businesses given their high costs (e.g. expensive premiums for issuance of the bonds by the private companies).[291,292]

(iii) Key features of a personal guarantee regime that facilitates credit for MSMEs[293]

143. As noted above (para. 136), an effective legal regime on personal guarantees for small business loans equally protects the rights of the guarantors and the financers

[286] See Luxembourg, Loi du 10 juillet 2020 relative aux garanties professionnelles de paiement. Available at https://legilux.public.lu/eli/etat/leg/loi/2020/07/10/a582/jo.

[287] The secretariat has added this paragraph on professional guarantees for completeness.

[288] For example, a survey released in 2020 by the regional federal reserve banks in the United States reported that nearly 60 per cent of small businesses with employees used personal guarantees to secure business debt. See R. Simon and H. Huddon, in Wall Street Journal, 4 April 2021, Small-business owners feel weight of personal debt guarantees.

[289] The COVID-19 pandemic has exacerbated the risks for personal guarantors and in certain States programmes have been launched to mitigate such risks. For example, in 2020 the United Kingdom banned banks from requesting personal guarantees for emergency loans to small businesses and combined this with a new loan scheme to support small businesses affected by the pandemic. See www.theguardian.com/politics/2020/apr/02/uk-banks-banned-from-requesting-personal-guarantees-for-loans.

[290] For example, India. See Working capital crisis: Can surety bonds assure MSMEs freedom from hassle of expensive bank guarantees, February 2022, available at Complete education to MSME&startup|MSME Ki Pathshala.

[291] For example, the United States.

[292] The secretariat has further elaborated on the topic of surety bonds as indicated in the Note to the Working Group placed after para. 97 of A/CN.9/WG.I/WP.126. However, additional research is needed to clarify the issue of costs in different countries and whether they make surety bonds a profitable option for MSMEs (A/CN.9/1090, para. 60).

[293] The secretariat has slightly revised the subheading for improved consistency with the focus of this subsection.

and does not discourage the latter from providing credit. Most countries do not seem to have a specific regime on guarantees for small business loans and general guarantees' law thus apply. Several provisions of general guarantees' regimes, for example protection of the guarantors or the rights and duties of parties of the guarantee agreement, are equally relevant for guarantees provided for small businesses' loans. Given the differences among domestic laws, the following paragraphs do not discuss in detail the technicalities of a legal regime on personal guarantees, but they outline characteristic features of an effective regime to support MSEs' access to credit as regards: the form of the personal guarantee, pre-contractual and contractual disclosure of information and clarity in the rights of the financers and guarantors. These features serve a dual purpose: they ensure the protection of the guarantor and at the same time provide certainty to all parties of the agreement.[294]

Note to the Working Group: *The secretariat will further research on the different approaches of domestic legislators to ensure protection of personal guarantors in the next iteration of the draft Guide.*[295]

a. Form of the personal guarantee

144. It is important for guarantors to properly assess their risk exposure when agreeing to assume the obligation to repay the MSEs' debts. Unexperienced entrepreneurs or entrepreneurs with poor financial literacy may not fully understand what a personal guarantee is and how it can affect their business and personal finances.[296] To minimize risks relating to the guarantor's lack of awareness, in most jurisdictions the law requires that any guarantee, regardless of whether it is provided for small business loans or not, satisfies certain formal requirements in order to be enforceable, such as the legal capacity of the guarantor to enter into a contract, written form,[297] an intention to be legally bound and the guarantor's signature.[298]

145. To further minimize the risks of unawareness, in other jurisdictions the legislations has established additional safeguards such as an explicit declaration of responsibility by the guarantor,[299] notarized written agreements (which may include an explicit limit of the amount of a guarantee for the guarantor to realize the risk the guarantor is taking);[300] or that the guarantors acknowledge their obligation under the guarantee before a lawyer, who must then confirm the acknowledgement by endorsement on the guarantee agreement.[301, 302] Balanced domestic regimes also

[294] The secretariat has amended the paragraph (A/CN.9/1090, para. 98) as follows: (i) second last sentence has been revised to highlight the guarantor's protection aspect in line with the deliberation of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 58) and (ii) the last sentence has been deleted to eliminate redundancy.

[295] For further reference, the Working Group may wish to refer to A/CN.9/1090, para. 58.

[296] See for example "SMEs don't understand personal guarantee in business loans", 2016, in https://smallbusiness.co.uk/smes-personal-guarantee-business-loans-2535607/. The results of this 2016 survey found that most of the entrepreneurs did not fully understand personal guarantees and their implications for their business and their personal finances.

[297] As to the meaning of "written form", it should be noted that not all States seem to accept electronic signatures (e.g. Germany). Instead, in certain States (e.g. Austria), electronically signed agreements are valid for those acting in the course of their business subject to the domestic legal regime on electronic signatures. See A. Schwartze, Personal Guarantees (supra, footnote 282), p. 376.

[298] L. Ellis, Where are the loopholes in Guarantees?, 2019, in https://hallellis.co.uk/unenforceable-guarantees-legal/.

[299] For example, Poland as cited in A. Schwartze, Personal Guarantees (supra, footnote 282), p. 376.

[300] For example, Japan.

[301] For example, the Canadian province of Alberta.

[302] It should be noted that in many countries these forms of protection seem to be mainly directed at consumers rather than legal entities. This may raise the issue of whether personal guarantees of owners, directors or members of MSEs may be qualified as consumers' guarantees and thus fall under the relevant legislation. There seems to be no harmonized approach across States on this question. See A. Schwartze, Personal Guarantees (supra, footnote 282), p. 379.

ensure transparency and legal certainty for both the financer and the guarantor by clearly establishing the moment at which the offer of a guarantee becomes effective.

Note to the Working Group: *The Working Group may wish to consider formulating a recommendation to address the form of the personal guarantee as discussed above.*

b. Pre-contractual and contractual disclosure of information[303]

146. As noted above, suretyships are often provided by non-professional individuals who do not have the knowledge and expertise required and are often unaware of all possible risks of such commitments.[304] In order to help them make an informed decision as well as facilitate a relationship based on trust and confidence between the parties, certain information should be disclosed to the guarantor before the issuance of the guarantee and throughout its term.[305]

147. In several countries, financers are thus required to explain to the guarantor the general legal and economic risks arising from the guarantee, including whether it is unsecured or secured. In addition, some countries find it important that the guarantor be informed of the more specific risks that are linked to the financial situation of the MSE. The fact that certain information on the financial situation of the MSE may be confidential does not affect the duty to inform, as the financer should obtain the MSE's consent for disclosure.[306] To ensure that the guarantor is fully aware of the potential risks of the guarantees, in some countries the financer advises the guarantor to seek independent legal and financial advice on the effects of the guarantee. As noted below (see para. 247), it is desirable that information be provided in an easy-to-understand language and in such a way that makes it possible to compare the conditions of the personal guarantee to similar contracts of other financers.

148. In order to be reminded of the long-term commitment and its potential risk, in several countries the guarantor receives regular communications during the guarantee period about the state of the guarantee. To allow the guarantor to better assess their risk exposure on an ongoing basis, it is advisable that the information provided covers both the principal obligation and any other ancillary obligations linked to it (see para. 154). While it is important for the law to require the periodic disclosure of relevant information, it should do so in a way that reduces the burden and cost for financers (for example, by simply requesting information on an annual basis).

149. In certain countries, to maximize its effects, the duty of disclosure is complemented by a risk-warning duty, so that the guarantor is notified of any circumstances that may affect its obligation to perform, such as the MSE's default. It is important that the law clarifies the content of the risk-warning which should at least include information about the secured amount of the principal obligation and any other ancillary obligations of the guarantor. For transparency and fairness, if the terms of the underlying obligation change in a way that may be prejudicial to the guarantor, the law may require the guarantor to be consulted and not simply informed as it may decide to withdraw from its commitment.[307]

Note to the Working Group: *The Working Group may wish to consider formulating a recommendation to address the pre-contractual and contractual duty of disclosure of information in the context of personal guarantee as discussed above.*

[303] For improved consistency of the text, the secretariat has moved this subsection here (subsection "c", paras. 105 to 108 of A/CN.9/WG.I/WP.126).
[304] M. Damjan, A. Vlhek (supra, footnote 279), p. 20.
[305] For improved consistency, the secretariat has deleted the phrase "depending on the length of the guarantee" before "throughout its term".
[306] M. Damjan, A. Vlhek (supra, footnote 279), p. 35.
[307] See for instance *Manulife Bank of Canada v. Conlin,* [1996] 3 S.C.R. 415.

c. Rights and obligations of guarantors and financers[308]

150. Uncertainty about the rights and obligations of the parties to a guarantee agreement may negatively affect their willingness to contract and thus reduce credit availability or increase its cost. Clarity of the applicable laws in this respect is essential for the mutual confidence of the parties and to reduce any possibility of contract abuse. Particularly important is clarity about the extent and scope of the guarantor's liability in the event of the MSE's default; the existence of any guarantor's contractual defences (e.g. extension of time on main debtor's obligation) not available to the main debtor and if such defences can be waived (and to what extent).

151. The guarantor's liability may be of either subsidiary or solidary nature. In the case of subsidiary liability, the financer must first request the principal debtor, i.e. the MSE, to perform its obligation before requesting the guarantor, although in certain jurisdictions the parties can agree that the financers seek direct repayment from the guarantor.[309] If joint and several liability (also known as "solidary" liability) is established, the financer can claim performance from the debtor or the guarantor (within the limit of the guarantee). That principle also applies among several personal guarantors that may have secured the performance of the same obligation. Most guarantee agreements nowadays contain a "joint and several" clause pursuant to which each personal guarantor is both jointly liable as a member of the group of guarantors and individually liable on its own to the financers for the repayment of the MSE's debt. This type of clause may easily become a cause of indebtedness for a guarantor who is requested to repay the full amount of the guarantee. That guarantor will have to recover the other guarantors' portion of the guarantee and face the risk of long and expensive court proceedings if the other guarantors cannot or refuse to pay. To mitigate risks of individual guarantor's over indebtedness and of distrust among the multiple guarantors which may negatively affect the MSE's operation, it is advisable that the domestic legal framework specifies the rights of each guarantor against the co-guarantors. The rights of the financer against the guarantors should also be clear as well as the guarantors' defences against the financer.[310]

152. Given the different extent of protection, domestic legislators may wish to specify whether a presumption of subsidiarity or solidarity of the liability exists – for example, the law may impose "joint and several liability" when the guarantee is silent in this respect[311] – and whether the presumption of liability is mandatory or can be modified by the parties and by which means (i.e. explicit agreement). For greater certainty, the legislators may also consider requiring the parties to expressly agree on the subsidiarity or solidarity of the liability when they enter into a guarantee contract. In case of subsidiary liability, it would be important for the law to specify the types of remedies against the principal debtor (if any) that need to be exhausted by the financers 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.[312]

153. As to the scope of the guarantor's liability, this could be limited to a particular period or amount of debt,[313] or not. A guarantee that is not limited in time or amount may be particularly risky for an MSE's guarantor who may become liable for multiple MSE's loans with the same financer without appreciating that its personal liability is increasing. Moreover, when the guarantor is the MSE owner, the guarantor may also be held liable for loans taken by the MSEs even after the business has been transferred

[308] Further to the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 61), the secretariat has revised the drafting of this subsection, which included amending the subheading and adding a new opening paragraph, to better highlight the rights and obligations of the parties to a personal guarantee agreement.
[309] See A. Schwartze, Personal Guarantees (supra, footnote 282), p. 375.
[310] The secretariat has added these two final sentences for improved clarity of the text.
[311] For example, North Carolina as cited in T. Wolff, in The National Law Review (supra, footnote 188).
[312] See A. Schwartze, Personal Guarantees (supra, footnote 282), p. 375.
[313] See M. Damjan, A. Vlahek (supra, footnote 279), p. 39.

to another entrepreneur. Many countries allow unlimited guarantees (in rare cases unlimited liability is allowed only in commercial relationships), while others only permit guarantees with a certain maximum amount.[314] Given the different extent of the guarantor's liability, it is desirable for the domestic law to clarify whether limited and unlimited guarantees are permitted and if specific requirements apply (e.g. an explicit agreement between the financer and the guarantor) in the case of unlimited guarantees. The law should also address instances when the guarantee was provided by a former MSE owner and specify if that guarantor can be released from its obligation or replaced by a new guarantor. Similarly, in the case of the guarantor's death, clarity would be needed on whether the successor(s) can obtain a release from the financer in order to avoid liability for an obligation they did not assume.

154. Finally, it is important for the law to clarify what other obligations the guarantor's liability should cover, if any, such as interests on the main obligation, damages for non-performance by the principal debtor, costs of legal remedies for the financer against the principal debtor. For example, in certain countries the cost of legal remedies is not covered by the guarantor unless there was an agreement between the parties.[315] Again, it might be desirable that for transparency, mechanisms are established to ensure that the guarantor is aware of the additional obligations the guarantee will cover.

Recommendation 3[316]

The law should:

(a) Clearly establish the rights and obligations of the financer and guarantor in a personal guarantee agreement; and

(b) Specify whether the liability of the guarantor is subsidiary or solidary to the obligation of the principal debtor.

d. Personal guarantees of MSE's owners or family members

155. As noted above (see para. 134), personal guarantees for MSEs' loans can be provided by the owner, a member of the family (often the spouse) or a friend. When the personal guarantee is provided by the owner or a family member, risks of over-indebtedness, attachment of family property or personal assets of family members may arise. To alleviate such risks, in certain countries, the private sector has developed insurance products that are often tailored to the needs of MSEs' owners. It is nevertheless important that the law also considers and addresses those risks with appropriate measures ranging from more stringent pre-contractual information disclosure duties to requirements of spouse consent, restrictions on the kind of guarantees that may be provided or limitations on the attachment of family or family members' property.

156. For the MSE owner to issue a personal guarantee, many countries require financers to explain the consequence of such guarantee to the owner's spouse or even obtain the written consent of the spouse before issuance.[317] In certain countries, however, there are exceptions to this rule and no consent might be needed under certain circumstances, for example if the guarantee is given in the ordinary course of business by the business owner or director.[318]

[314] I.e. Denmark. See A. Schwartze, Personal Guarantees (supra, footnote 282), p. 378.
[315] For example, Austria, Denmark and Greece. See A. Schwartze, Personal Guarantees (supra, footnote 282), p. 378.
[316] The secretariat has added this recommendation as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 62).
[317] For example, Austria, Brazil, the Netherlands and Switzerland as referred to in A. Schwartze, Personal Guarantees (supra, footnote 282), p. 380.
[318] For example, the Netherlands, available at: www.bbvlegal.com/spousal-permission-needed-for-personal-guarantee/, and Turkey, available at: https://ongorenlaw.com/the-consent-of-the-spouse-

157. When family members are requested to provide personal guarantees in favour of the MSE, they not only put their personal assets at risk, but may also jeopardize the financial stability of the household and the interpersonal relations of its members. Only a few countries, however, seem to have laws concerning guarantees provided by family members of the MSE's owners or other persons closely related to them. In some countries, courts protect those vulnerable guarantors applying the doctrines of violation of fiduciary relationship, or unconscionability[319] or undue influence whose application is not limited to personal guarantees. Courts have also declared the guarantees of a related person unenforceable when such person has no relevant asset or income (on the grounds that the guarantee is deemed as taken abusively with a view to exploit the weaker condition of the borrower).[320] In other countries, the courts have held that it is illegal for a financer to require a spousal guarantee for the sole reason that the prospective guarantor is married to the person seeking the loan.[321,322]

158. The importance to ascertain that the guarantor is acting on the basis of adequate and neutral information has also been noted, in particular if the guarantor may incur special risks arising from the financial situation of the MSE and in light of the guarantor's personal ties with the MSE owner. For example, in some countries insolvency law treats personal guarantees by family members of the debtor as subordinated debt – a circumstance the guarantor should be made aware of.[323] It has thus been suggested that the financer should ascertain that the guarantor has received independent advice and has had sufficient time to make an informed decision about an obligation that may be financially and emotionally burdensome.[324]

Note to the Working Group: *The Working Group may wish to consider formulating a recommendation to address the issues concerning personal guarantees of MSE's owners, family members or friends as discussed above.*

e. Enforcement of the guarantee

159. If the MSE keeps up with the loan payment according to the terms of the loan, there is usually not much risk for the guarantors. However, when an MSE is in financial distress, the solvency of the personal guarantors may be affected. If the guarantor is unable to repay the debts, enforcement of the guarantee may result in a lifetime of debt for the guarantor and its family, depending on domestic legislation, and strong social stigma in certain countries. In some jurisdictions, disproportionate hardship on the personal guarantor can be mitigated by personal insolvency regimes that relieve the guarantors of their unpaid claims after partial payment or instalment payments over time.[325] Such debt discharge allows the guarantors to continue their regular economic life and when the guarantor is the MSE's owner, such discharge facilitates its return to activity and may also enhance its willingness to do so.[326] However, not all countries have adopted personal insolvency laws, and some of those

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will-not-be-needed-in-regard-to-the-guarantee-agreement/. The secretariat has added the phrase "and the…of business" for additional clarity.

[319] In Canada's common law "a transaction is unconscionable where a stronger party has exploited the weakness of another in order to obtain a benefit at the weaker party's expense", see Canadian Centre for Elder Law Studies, Financial Arrangements Between Older Adults and Family Members: Loans and Guarantees, 2004, p. 9.

[320] See Germany, Bunderverfassunggericht 6 December 2005 (1BvR 1905/02) as cited in L. Gullifer, I. Tirado, Financing Micro-businesses and the UNCITRAL Model Law on Secured Transactions, 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3033114.

[321] See for example Hawkins v. Community Bank of Raymore (United States Court of Appeals for the Eighth Circuit and Supreme Court).

[322] The secretariat has moved this sentence here (last sentence of para. 111 of A/CN.9/WG.I/WP.126) for improved consistency of the text.

[323] Further to comments of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 64), the secretariat has highlighted the importance of providing sufficient information to a family member who may incur special risks from granting a personal guarantee).

[324] See M. Damjan, A. Vlahek (supra, footnote 279), pp. 35–36.

[325] D. Hahn, "Velvet Bankruptcy", in Theoretical Inquiries in Law, 2006, vol. 7, p. 541.

[326] Ibid., p. 540.

that implement them may have no discharge mechanisms or have a long waiting period before discharge, as well as heavy penalties for personal bankruptcy.[327]

160. Adopted at the fifty-fourth session of UNCITRAL (2021), the *UNCITRAL Legislative Guide on Insolvency Law for Micro- and Small Enterprises* (the *Legislative Guide*) recommends a simplified procedure to address personal guarantees provided for business needs of the MSE by individual entrepreneurs, owners of limited liability MSEs or their family members when invoking the personal guarantee would likely result in the personal insolvency of the guarantor. This may be achieved through procedural consolidation or coordination of the relevant proceedings, that is insolvency proceedings against the MSE and insolvency or enforcement proceedings against its guarantors. When no proceeding against the guarantor has commenced, the *Legislative Guide* clarifies that the law may allow the guarantor to bring potential claims of creditors for consideration in the insolvency proceeding commenced against the MSE so that those claims could be accorded appropriate treatment with the purpose of preventing potential insolvency of the guarantor. For example, the law may permit imposing a stay on the enforcement against personal guarantors of the MSE for a limited duration on a case-by-case basis. When approving or confirming a reorganization plan of an insolvent MSE, the competent authority may accord special treatment to a guarantor's claim against the MSE vis-à-vis other claims in the plan. The insolvency law may permit MSE' guarantors to petition for a reduction or discharge of their obligations under the guarantee if those obligations are disproportionate to the guarantor's revenue and may also permit the guarantor to pay in instalments for an extended period. The competent authority or another relevant State body may be allowed to exercise discretion in favour of the guarantor's discharge or the reduction of the obligation to the part of the debt not covered by the MSE's repayment obligations. These measures may alleviate a disproportionate hardship on the guarantor.[328]

161. The *Legislative Guide* also suggests that special measures of protection may be envisaged in the law, other than insolvency law, for especially vulnerable guarantors, e.g. those who are found to have provided guarantees under duress or those who are dependent on or have strong emotional ties with the debtor (see para. 157 above).

Note to the Working Group: *The Working Group may wish to consider whether to recommend the use of existing international standards that are relevant to the enforcement of personal guarantee as discussed above.*

B. A legislative framework supportive of equity tools to enhance MSME access to credit[329]

162. While most of the challenges faced by MSMEs and financers when using equity tools would require attention through policy, taxation and regulatory measures, corporate law, including business registration norms, play an important role in providing incentives for equity investment. This section will discuss suggested improvements to existing legal frameworks concerning corporate governance that permits small businesses to migrate from informal to formal economy, offers limited liability protection to investors and imposes record-keeping requirements. The section will also outline the role of simplified business registration in encouraging MSME formalization.

[327] World Bank, Report on the Treatment of MSME Insolvency, 2017, p. 34.
[328] A/CN.9/1052, annex, para. 93 and A/CN.9/WG.V/WP.172/Add.1, paras. 330 to 335.
[329] The secretariat has placed this section (section E, chapter IV, of A/CN.9/WG.I/WP.126) here as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 33).

1. Business formation and operation[330]

163. As noted earlier, many of the obstacles MSMEs experience in accessing credit are exacerbated by operating in the informal economy. Without a formal status, MSMEs have no access to the banking sector and must rely on family and friends support, microcredit or other informal channels which are rarely a guaranteed source of financing. In several countries business formalization may be an expensive and burdensome process with entry requirements (e.g. minimum capital) that particularly MSEs cannot meet, thus preventing the formalization of many potentially viable small businesses. Several countries of different legal traditions have reformed their laws and adopted simplified legal forms for the MSME category to facilitate formalization of such businesses.

164. The *UNCITRAL Legislative Guide on Limited Liability Enterprises* (the "LLE Guide"), adopted in July 2021, distils the good practices and key principles emerging from those reforms into a series of recommendations on how a State could devise and regulate a simplified legal form for MSMEs that can best facilitate their formation and sustainability, thus stimulating entrepreneurship. Such simplified legal form could facilitate the economic inclusion of women and other entrepreneurs who may face unfavourable cultural, institutional and legislative frameworks such as youth and ethnic minorities.[331]

165. Particularly relevant for MSME access to credit are the recommendations in the LLE Guide to grant legal personality to the MSME and limited liability to its owners. Distinct legal personality of a business and limited liability of its owners usually go hand in hand. Having a distinct legal personality, the MSMEs becomes a legal entity separate from its members[332] – a protective measure that MSMEs in several countries cannot enjoy. As an essential consequence of the MSME's legal personality, its members are not personally liable for its obligations and debts solely by reason of being members of the MSME.[333] Limited liability permits the MSME owners (and the equity investors) to take business decisions without concern that they may jeopardize their personal assets if the MSME does not perform well or becomes involved in legal disputes. This is important both for the protection of the MSME owners and for the promotion of innovation and business creation, as it allows entrepreneurs to take business risks without incurring direct or indirect personal liability as a result of the activities of the MSME.[334] In effect, the financial liability of a member of the MSME is limited to a fixed sum, usually the value of the member's contribution to the MSME. Limited liability of owners and distinct legal personality of the MSMEs could help attract equity investors, assist in promoting the stability of the MSME and access by it to lower cost credit.[335]

166. Last but not least, the LLE Guide recommends that the MSME must keep certain records including of: (a) information provided to the business registry; (b) the organization rules, if and where such rules have been adopted in writing or otherwise recorded; (c) identity of past and present designated managers, members and beneficial interest owners of legal entities, if any, as well as their last known contact details; (d) financial statements, if any; (e) tax returns or reports; and (f) the activities, operations and finances of the MSME.[336] Building a good record of information concerning the MSME, particularly financial statements and other records of finances, could help attract future equity investors (and also access more easily formal financial institutions) in the light of the increased credibility of the MSME and reduced costs associated with due diligence.

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[330] The secretariat has revised this section to better place the discussion on business formalization and the UNCITRAL Legislative Guide on Limited Liability Enterprises in the context of access to credit.

[331] UNCITRAL Legislative Guide on Limited Liability Enterprises, para. 4 (to be published soon).

[332] Ibid., recommendation 3 (to be published soon).

[333] Ibid., recommendation 4 (to be published soon).

[334] Ibid., para. 32 (to be published soon).

[335] Ibid., para. 33 (to be published soon).

[336] Ibid., recommendation 30 (to be published soon).

2. Business registration[337]

167. In addition to incorporation, another entry point to access the formal economy is by way of registration with certain public authorities (often the business registry, but also the taxation or social security authorities). In many countries, registration with the business registry is required of enterprises of all sizes and nature wishing to formalize. Similar to business incorporation, however, registration procedures might be overly burdensome and expensive for many small businesses, which may outweigh their interest in operating in the formal economy.

168. The *UNCITRAL Legislative Guide on Key Principles of a Business Registry* (2019) (the "Business Registry Guide") sets out key principles and good practices in respect of business registration, and how to achieve the necessary reforms. It aims at simplifying and streamlining business registration in order to promote the formalization of MSMEs, thus increasing their opportunities to obtain financing, and improve their visibility to the public and the market. The Business Registry Guide also suggests putting in place incentives for MSMEs and other businesses to comply with registration requirements. Such incentives will vary according to the specific economic, business and regulatory context, and may include promoting access to credit for registered businesses.[338] In the context of government subsidies or programmes to foster MSME growth (such as measures during the COVID-19 pandemic), unregistered businesses are likely to miss out on such benefits.

169. The Business Registry Guide also encourages the registration of businesses that would not otherwise be required to register with the business registry (but may be subject to mandatory registration with other public authorities, such as taxation and social security) and allows such businesses to benefit from a number of services offered by the State, by the registry and other entities, including facilitating access to credit.[339]

170. To promote accountability and transparency and to improve their access to credit or attract investment, MSMEs may wish to submit and make public their financial information.[340] While MSMEs are not generally required to provide the same flow and rate of information as publicly held firms, they may have strong incentives for doing so, particularly as they develop and progress. Businesses wishing to improve their access to credit or to attract investment may wish to signal their accountability by supplying information on, for example, their financial position and capital needs (including profits and dividends), as well as information concerning the management board. Such considerations are not likely to occupy MSMEs that remain small but could become important as they grow.[341]

171. Last but not least, women-run MSMEs are often over-represented in the informal economy. Finance gaps are likely to be greater for such businesses than for men-owned MSMEs in most countries due to cultural biases or economic, social and legal constraints (see para. 6). In this respect, the Business Registry Guide specifically recommends that women should have equal and enforceable rights of access to the business registration services, and the requirements for business registration should not discriminate against potential registrants due to their gender.[342] Policies should also be put in place to collect anonymized, sex-disaggregated data for business registration on a voluntary basis through the business registry, which may help States

[337] The secretariat has moved this section under this part of the draft Guide since business registration is also relevant for MSMEs wishing to formalize. The secretariat has also revised this section to better highlight the relevance of registration in the context of access to credit.
[338] UNCITRAL Legislative Guide on Key Principles of a Business Registry (2018), para. 23.
[339] Other benefits include the protection of a business or a trade name, accessing additional opportunities for growth, improving visibility to the public and to markets. See Ibid., para. 125.
[340] Ibid., para. 155.
[341] Ibid., footnote 20,p. 63.
[342] Ibid., recommendation 34.

determine the extent of informal barriers to establish a gender-neutral business registration framework.[343]

Note to the Working Group: *The Working Group may wish to (i) consider whether to recommend the use of existing international standards concerning business incorporation and corporate governance as well as simplification of business registration as discussed in the two sections above, and (ii) identify other possible areas for future improvement to facilitate the use of equity tools for MSMEs to access credit.*

C. Other measures to enhance MSME access to credit

172. As noted earlier (see para. 98), in addition to legislative measures several policy and regulatory measures also play a significant role in facilitating access to credit for MSMEs. This part of the draft Guide thus addresses certain interventions (for example, credit reporting, restructuring support, dispute resolution mechanisms) that at a minimum a State should implement in order to support small businesses' access to credit.[344]

1. Credit guarantee schemes[345]

173. In many countries, in particular those with emerging economies or economies in transition, credit guarantee schemes represent a key policy tool to address the financing gap of MSEs that in most countries are the main beneficiaries of such schemes (as opposed to medium-sized enterprises).[346] Credit guarantee schemes lower the risk in lending of financial institutions since they guarantee, usually in return for a fee paid by the financial institution or MSE or both, repayment of all or part of the loan granted by the financial institution to the MSE in case of the MSE default. The payment of the defaulted loan entitles the credit guarantee scheme to claim the paid amount back from the MSE (see paras. 192 to 197).

174. As additional benefits, credit guarantee schemes may facilitate financial institutions overcome the problem of information asymmetry and reduce the low profitability of lending to MSEs[347] and they may also facilitate MSE access to formal credit, since they either eliminate or alleviate the need for collateral requirements, which an MSE may not meet, thus improving the terms of the loan for the MSE. Other benefits have been noted, although their extent is still debated. That is, credit guarantee schemes may help the financial institutions gain experience in managing loans for MSEs, thus encouraging further developments of this market segment; and they may help MSEs that would have been excluded from the lending market to establish a repayment reputation that can facilitate future lending from financial institutions.[348]

175. 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, usually established by the private sector (e.g. banks and chambers of commerce) which generally benefit from the direct involvement of the banking sector; (iii) mutual guarantee schemes that are private and independent organizations formed and managed by MSEs with limited access to bank loans; and

[343] Ibid., recommendation 34 and para. 175.
[344] The secretariat has revised the opening paragraph of this section to ensure consistency with the reorganized draft Guide.
[345] The secretariat has revised the drafting of several paragraphs in this section to eliminate use of prescriptive language, as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 76).
[346] Since MSEs are the main beneficiary of credit guarantee schemes, this section focuses on such businesses (and mainly uses the acronym MSEs).
[347] OECD, Discussion Paper on Credit Guarantee Schemes, 2010, p. 4.
[348] Ibid., pp. 4–5.

(iv) international schemes established by bilateral or multilateral government or IGO/NGO initiatives, which often combine a guarantee fund with technical assistance programmes.[349] 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.[350]

(a) Public credit guarantee schemes

176. Public credit guarantee schemes are one of the main public support mechanisms to facilitate MSEs' access to credit. Other mechanisms with a similar scope include direct lending programmes, facilities for the pledging of MSE loans as collateral against refinancing from central banks, tax and interest rate subsidies.[351] Different objectives may motivate those State's interventions, for example closing the financing gap of MSEs, 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 MSEs are often the main motivating factor behind a State's direct support to MSEs. Public credit guarantee schemes have proven to be a particularly effective countercyclical tool to address the negative consequences of the credit market failure resulting from those crises or events.[352]

177. Neither public credit guarantee schemes or other public support mechanisms, however, may be a substitute for an efficient market-based lending, as they may create markets distortions, such as channel funds to unproductive MSEs or prolong the existence of companies that should be liquidated or prevent the diversification of financing sources.[353] Public credit guarantee schemes in particular may disadvantage companies that are ineligible to access the guarantee schemes; disincentivize financial institutions to carry out proper due diligence, especially when the credit guarantee scheme covers the full amount of the loan loss; create risk of improper use of taxpayers' money which funds such guarantee schemes; and disincentivize MSEs to grow into medium-sized enterprises given that they may no longer be eligible for public credit guarantee schemes.[354] To avoid such risks and maximize their benefits, it may be advisable to use public credit guarantee schemes and other public support mechanisms as supplementary measures to market-based lending in order to correct those problems that private lending mechanisms cannot address. This would also permit countries to widen the opportunities for MSEs and financers to engage in financing transactions. For example, public credit guarantee schemes can motivate a financer to extend additional unguaranteed credit to an MSE that has already obtained a loan covered by a credit guarantee scheme from the financer.[355]

Criteria for effective public credit guarantee schemes

Foundations of public credit guarantee schemes

178. The principles of accountability and transparency as well as the efficient and proper use of public resources should guide the operation of the credit guarantee

[349] Ibid. pp. 7–8.
[350] See for instance, https://www.oecd.org/mena/competitiveness/ismed-export-credit-agencies.htm. The secretariat has added this reference to external credit guarantee schemes as suggested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 78).
[351] M. Dubovek and S. Owada, Secured Lending Stimulants: the Role and Effects of Public Credit Guarantees in Japan, U. PA. ASIAN L. REV. Vol. 16, 2021, p. 378.
[352] Ibid., pp. 374–427.
[353] Ibid., p. 416.
[354] The World Bank and FIRST Initiative, 2015, Principles for Public Credit Guarantee Schemes for SMEs, p. 120.
[355] At its thirty-seventh session, the Working Group requested the secretariat to clarify in this paragraph (para. 166 of A/CN.9/WG.I/WP.126) that credit guarantee schemes are not an alternative to market-based lending (A/CN.9/1090, para. 77). The secretariat has thus replaced the last sentence of the paragraph to stress the complementary nature of credit guarantee schemes and market-based lending.

scheme.[356] States can ensure them through the following criteria: establishing ex ante the credit guarantee schemes' objectives and performance criteria, regularly evaluating the performance of the schemes[357] and their positive and negative impact on the market. While commercial laws and mechanisms for the fair resolution of disputes, including out-of-court proceedings, play a key role in creating an enabling environment for credit guarantee schemes to operate, the design and operation of efficient schemes rely on a mix of legislative and regulatory measures that usually take into account the legal foundations of the scheme, eligibility criteria for MSEs and financial institutions and loan coverage, mitigation of risk, collateral requirements, fees and sustainability and recovery of any loan loss by the credit guarantee schemes.

179. The World Bank and FIRST Initiative *Principles for Public Credit Guarantee Schemes for SMEs*, prepared in 2015,[358] indicate that such legal and regulatory framework could be a part of corporate or banking legislation or institution-specific legislation. In States where the guarantees are provided directly by the central government, and not by independent entities established for that purpose (see para. 180), it is desirable that the State's liability with respect to the provision of the service be addressed in the applicable laws.

180. Public credit guarantee schemes can be established as an independent entity with legal personality, while allowing the government to retain ownership and control over it. In the latter case, the applicable legal and regulatory framework should clarify (i) how the State will exercise its ownership; (ii) who will represent it (e.g. a ministry or an agency etc.) and which government body will supervise the scheme; (iii) general terms and conditions that apply to the government investment; (iv) the relationship between the State as shareholder and the scheme's board and management; and (v) the scheme's funding sources. If the State chooses to establish the credit guarantee scheme in partnership with the private sector, clearly defined responsibilities and obligations of both parties would help protect the rights of the minority shareholders, often the private sector entities, and promote their active participation in the governance and decision-making processes.[359]

181. In order to operate efficiently, it is important that the mandate specifies the MSE sector(s) targeted by a credit guarantee scheme and its main line(s) of business, defined broadly enough to accommodate cyclical developments in the targeted sector(s).[360] Equally important is to have in place mechanisms for the periodic review of the mandate in order to assess its continuing validity over time. In addition to the provision of credit guarantees, the mandate may include other services, such as provision of information, technical assistance, training and counselling.[361] Managerial autonomy and accountability of the credit guarantee schemes in implementing the mandate are key and they can be better ensured if the day-to-day operation of the credit guarantee scheme is not subject to political influence.[362] Without adequate funds, a credit guarantee scheme cannot implement its mandate effectively. To ensure that funding is available at an adequate level it is desirable that the legal or regulatory framework establish the amount required and specify the

[356] As requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 76), the secretariat has added reference to "transparency" of public credit guarantee schemes at the outset of the discussion. In addition, it has highlighted the importance of "accountability" of the schemes.

[357] See, EBCI- Vienna Initiative, Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe – a report by the Vienna Initiative Working Group on Credit Guarantee Schemes, 2014, p. 55.

[358] The Principles cover four areas: (i) legal and regulatory framework; (ii) corporate governance and risk management; (iii) operational framework; and (iv) monitoring and evaluation. This section of the draft Guide focus on those aspects of the Principles that are relevant for its scope.

[359] The World Bank and FIRST Initiative (supra, footnote 354), p. 14.

[360] Ibid., p. 15.

[361] Ibid.

[362] The secretariat has replaced the term "government oversight" with reference to political influence over the public credit guarantee scheme as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 77).

responsibility of the State with regard to the provision of the initial capital and additional subsidies during the life of the credit guarantee scheme.[363]

182. As contingent liabilities, public credit guarantee schemes can expose the State to significant budget risks resulting in unanticipated cash outflows and increased debt. To mitigate such risks, it is important that the State carries out a long-term assessment of their budgetary implications before establishing a credit guarantee scheme. A thorough fiscal risk assessment usually considers the factors that are likely to affect the overall financial balance of the scheme as well as the options for risk allocation between the parties (i.e., credit guarantee scheme, lending financial institutions and borrowers) involved in the scheme.

Eligibility criteria

183. Efficient credit guarantee schemes rely on clear and transparent eligibility criteria concerning MSEs, lending financial institutions and loans that should be publicly available and regularly reviewed. Transparency and clarity of such criteria also allow the State to avoid an improper use of the public funds invested in the operation of the credit guarantee scheme. With regard to MSEs, it would be important to clarify whether the eligible MSE could be incorporated or a sole proprietor as well as the sector where they operate. Additional criteria may include the size (typically defined by the maximum number of employees, value of assets, and sales), the subsector,[364] or a minimum operation time.[365] In certain States, legal requirements may include a link with the jurisdiction where the guarantee is provided, for example the place where the business is conducted.[366] It is advisable that States can broaden the eligibility criteria of the businesses benefiting from the scheme in case of major financial crisis or other emergencies that have an impact on the domestic economy.[367]

184. Consistent with the applicable legal and regulatory framework, credit guarantee schemes could establish programmes dedicated to subclasses of firms[368] such as start-ups, exporters, and high-tech firms or target specific entrepreneurs' groups such as women or youth in order to encourage entrepreneurship in those segments. Conversely, the schemes may create a list of ineligible MSEs (on the basis of their credit profile and repayment reputation, for example)[369] or may explicitly exclude some subsectors from their scope of operations.[370]

185. Lending financial institutions also benefit from clear eligibility criteria, possibly determined on the basis of objective indicators such as their capacity in serving small

[363] The World Bank and FIRST Initiative (supra, footnote 354), p. 13.
[364] Ibid., p. 18.
[365] See for instance the Malaysian BizSME scheme that requires a minimum time in operation often ranging from 1–5 years.
[366] In certain cases, see the United Arab Emirates, an ownership or management by nationals of that jurisdiction is also required in order to avoid disbursing guarantees to enterprises without a genuine link to the supporting jurisdiction. In other cases, for example Ireland, the credit guarantee scheme may exclude enterprises which are part of a wider corporate group or a significant share of which is owned by public bodies or foreign investors.
[367] For example, during the COVID-19 pandemic, many countries broadened the eligibility criteria to include specific industries or businesses, even large companies, operating in strategic sectors. See IMF, Special Series on COVID-19, 2020, Legal Considerations on Public Guarantees Schemes Adopted in Response to the COVID-19 Crisis, p. 2.
[368] Some credit guarantee schemes are designed specifically to aid enterprises conducting business in certain sectors considered vulnerable or disadvantaged with regard to credit access, such as farming or manufacturing businesses (see for example the Nigerian Agricultural Credit Guarantee Scheme Fund).
[369] In Malta and Ireland, businesses which have been declared bankrupt, or have entered into restructuring agreements with creditors or whose managerial or executive staff have been convicted of professional misconduct such as fraud, corruption or money-laundering may be excluded.
[370] For example, in Lithuania support is not granted to firms operating in gambling, ammunition, tobacco and alcohol production and sales.

businesses and their risk management capabilities.[371,372] Typically,[373] eligible financial institutions include, but are not limited to, commercial and development banks, licensed credit institutions or supervised non-bank financial service providers, [374] credit cooperatives,[375] or not-for-profit entities with the primary purpose of supporting small businesses' development. [376] 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.[377]

186. Finally, clear laws or regulations on which types of loans are eligible for coverage would avoid discretionary or arbitrary decisions by the credit guarantee scheme that might jeopardize its effectiveness. In this respect, it would be desirable that both loans for operational expenses (e.g. salaries, rent, utilities) and for investment finance be included, since the former help sustain jobs in MSEs that are vulnerable to insolvency because of insufficient short-term credit, and the latter assist job creation and long-term economic growth.[378]

Mitigating the risks of public credit guarantee schemes

187. As noted above, public credit guarantee schemes may expose the governments to high fiscal risks since the State may lack the necessary funds to service the obligations arising from invoked guarantees, in particular in times of crises. As a general principle, decisions to establish a public credit guarantee scheme should thus follow a process that ensures that policymakers understand the risks associated with the credit guarantee scheme. This could range from informing the parliament about the type and implications of the scheme and how they could affect the public budget to receive parliament approval on establishing the scheme. In addition, when designing the credit guarantee scheme, States may use different mechanisms to mitigate the risks of its functioning. For example, they may introduce a maximum ceiling, either as a fixed sum or as a percentage, on the overall exposure of the scheme. The ceiling can be standing or revised at defined intervals. Alternatively, they may decide to set a cap to the size of individual loans guaranteed under the credit guarantee scheme.[379] States may also opt to implement a risk-based fee policy where higher guarantee fees are to be paid for riskier loans. This may involve defining different risk categories, with each category having a standard predetermined fee.

188. One of the most common ways to limit the risk of moral hazard of the lending financial institutions is through the establishment of partial guarantees that use the mechanism of the coverage ratio to determine the percentage of the loan exposure

[371] The World Bank and FIRST Initiative (supra, footnote 354), p. 18.
[372] Some countries do not explicitly set or publish general eligibility criteria for lending financial institutions (for example, Slovenia), whereas others designate eligible lending financial institutions by means of general-abstract criteria (e.g. Chile) or through an (exhaustive) list of accredited institutions which have undergone a screening procedure (e.g. India or New Zealand).
[373] The secretariat has improved this sentence for further clarity of the text.
[374] For example in the Philippines.
[375] For example in Brazil.
[376] For example in Egypt, where the SEB programme is implemented through contracting NGOs.
[377] For instance, during the COVID-19 pandemic, some States have included in the lenders' category non-bank financial entities (such as electronic money entities and payment service providers in Spain or the national postal service in Switzerland). See IMF, Special Series on COVID-19 (supra, footnote 367), p. 2 and M. Dreyer and K. Nygaard, 2020, Lessons Learned in Designing and Implementing Support for Small Businesses, available at: https://som.yale.edu/blog/lessons-learned-in-designing-and-implementing-support-for-small-businesses. See also the examples of the Philippines, Canada or Australia. To be considered eligible for participation in such credit guarantee schemes, applicants may be required in some way to demonstrate that they have been affected by COVID-19, e.g. through non-materialization of expected and regular cashflows or turnover or by additional operating costs under the conditions imposed by the pandemic.
[378] The World Bank and FIRST Initiative (supra, footnote 354), pp. 18–19.
[379] During the COVID-19 pandemic, many States temporarily increased the cap on the size of loans using criteria such as the type and size of the business, or the MSE revenues. In certain States, applicable laws allowed case-by-case exceptions in case of national security interest, job protection, or relevance of the business for the national economy. See IMF, Special Series on COVID-19 (supra, footnote 367), p. 3.

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 MSE default, while encouraging them to regularly monitor the MSE performance. For example, a high coverage ratio can be very attractive to lending financial institutions, since they would be protected from credit risk and may not have an incentive to engage in proper risk screening and monitoring activities thus leading to excessive risk-taking (e.g. extending credit to high-risk MSEs) and endangering the schemes' sustainability.[380] On the contrary, if the credit guarantee scheme bears only a small share of the risk, financial institutions might disregard the programme.[381] 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 MSE's credit performance.[382] The coverage ratio should be clearly indicated in the contractual agreement between the credit guarantee scheme and the financial institution and the agreement should also clarify how the losses are to be shared between the two parties.

189. Since the allocation of risks between the credit guarantee scheme and the lending financial institutions is affected by their respective roles and responsibilities, it is important that the legal framework clearly defines such roles and responsibilities. Good practice would be to clarify that the lending decisions rest on the sole discretion of the financial institution and the criteria on which such decisions should be based (e.g. the MSEs' creditworthiness; how the guaranteed loan fits into the financial institution business and risk appetite; whether the guaranteed loans could be used as collateral to access central bank liquidity facilities) and that the CGS is responsible for approving the specific guarantees.[383]

190. There may be moral hazard on the part of the MSE too, since it might provide misleading information or not disclose sensitive information to the lending financial institution and risk-sharing practices may help prevent it. A recommended practice is to require the MSE to supply collateral as it demonstrates its commitment to repayment. However, excessive collateral requirements can defeat the purpose of the guarantee and the credit guarantee scheme should work with the lending financial institution to determine an appropriate level of collateral requirement that limits the moral hazard of MSEs but does not disincentivize them to apply for loans.[384]

Fees

191. The guarantee's fee 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. When determining the fees, it is good practice to strike a balance between the goals of the guarantee's programme 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 the expected cost of credit risk. Transparency of the pricing policy helps make the credit guarantee scheme attractive to its potential users. The possibility to adjust fees on the basis of the country's specific circumstances ensures the sustainability of the scheme.[385] For example, in response to major crisis

[380] IMF, Special Series on COVID-19 (supra, footnote 367), p. 2.
[381] R. Ayadi and S. Gadi, Access by MSMEs to Finance in the Southern and Eastern Mediterranean: What role for credit guarantee schemes?, MedPro Technical Report, 2013, p. 11.
[382] At its thirty-seventh session, the Working Group agreed (A/CN.9/1090, para. 77) to reflect in this paragraph (para. 177 of A/CN.9/WG.I/WP.126) that the coverage ratio can affect financers' monitoring of borrowers' performance. The secretariat has implemented that deliberation by adding two new sentences: (i) after the opening sentence; and (ii) before the final one.
[383] IMF, Special Series on COVID-19 (supra, footnote 367), p. 4.
[384] The World Bank and FIRST Initiative (supra, footnote 354), p. 20.
[385] The secretariat has deleted reference to adjusting the credit guarantee schemes' fees on the basis of credit loss history and market developments as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 77).

affecting their overall economic structures, certain States set caps on the amounts of fees that can be charged or prohibited the charging of fees.[386]

MSE default and loan loss recovery

192. A timely and transparent process to manage MSE default and subsequent claims from the lending financial institutions is key for an efficient operation of the credit guarantee scheme and to build and maintain the confidence of the lending institutions in it.[387] This can be achieved when the legal or regulatory framework and the contractual arrangements clarify the precise circumstances that prompt the credit guarantee scheme's intervention, for example the opening of insolvency proceedings against the MSE or the MSE's late repayment of the loan.[388]

193. In some jurisdictions,[389] the guarantees issued by credit guarantee schemes are considered independent guarantees, where the guarantor's obligation is not linked to the underlying debt (see para. 137). In others, the credit guarantee scheme has a subsidiary liability[390] (see para. 139) whereby the enforcement or validity of the guarantee is dependent on that of the principal debtor, but a provisional payment by the scheme to the financial institution may be made based on expected losses after a default. If the enforcement of guarantees by the financial institutions is linked to the occurrence of "losses", clarity is needed on when and how such losses will be deemed to exist and borne by the financial institutions.[391] It would however be desirable that before submitting their claims, lending financial institutions proactively explore alternative solutions, including loan rescheduling, to receive payment from the MSE.[392]

194. 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 scheme and the financial institution stating the conditions under which a claim is acceptable, 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 schemes after loan disbursement and it has been suggested that the maximum period after a missed payment(s) should also be specified and should not be conditional on initiating legal action against the MSE.[393] In addition, it is advisable that the agreements require a detailed written explanation if the claim is refused.[394]

195. Finally, clarity is required in relation to the credit guarantee scheme's rights once it has paid the guarantee.[395] The general legal principle is that the rights or claims of the lending financial institution against the MSEs 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 will 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. An underlying condition for the effective implementation of the statutory subrogation, it is of course

[386] For example, the crisis generated by the COVID-19 pandemic. With this regard see IMF, Special Series on COVID-19 (supra, footnote 367), p. 3.
[387] The World Bank and FIRST Initiative (supra, footnote 354), p. 22.
[388] Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH (GIZ), SMEs' Credit Guarantee Schemes in Developing and Emerging Economies: Reflections, Setting-up Principles, Quality Standards, 2014, p. 59.
[389] For example, Italy and the United States. IMF, Special Series on COVID-19 (supra, footnote 367), p. 5.
[390] For example, France and the Netherlands. Ibid., p. 5.
[391] Ibid.
[392] The World Bank and FIRST Initiative (supra, footnote 354), p. 22.
[393] Ibid.
[394] Ibid.
[395] Ibid.

that the domestic legal framework recognizes the subrogation of the public credit guarantee scheme as legally enforceable. To reinforce their subrogation rights, certain credit guarantee schemes may conclude a separate agreement with the MSE under which this latter agrees to indemnify the scheme in respect of any payment made.

196. A public credit guarantee scheme may be subrogated to the rights of too many lending financial institutions, which may pose a threat to its financial sustainability. In order to mitigate such risk, it has been suggested that the credit guarantee schemes could convert guaranteed loans into equity or quasi-equity instruments and transfer the exposures to other public institution (such as development banks) or specialized investment vehicles, which can better manage those positions. In the case of guaranteed loans of micro enterprises, converting the debt into a quasi-equity instrument, for example a future tax obligation, might be a more viable option, given the high costs of monitoring an equity investment.[396]

197. If the credit guarantee scheme provides only partial guarantees, both the scheme and the lending financial institution may have a claim against the defaulted MSE. 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 MSE. To maximize the results, it may be convenient for the credit guarantee scheme to entrust the financial institution with this task, since financial institutions have typically more tools to acquire information about the MSE and potentially stronger incentives to recover the debt. In certain States,[397] for example, the lending financial institution is required to act as the agent of the credit guarantee scheme during the enforcement stage.[398]

(b) Private guarantee schemes

198. As noted above (see para. 175), credit guarantee schemes may also be directly funded and operated by the private sector and they can take the form of corporate guarantee or mutual guarantee schemes. The former can be limited liability companies or public limited companies governed by company law. In certain jurisdictions, corporate guarantee schemes are considered as specialized financial institutions and their prudential regulation is aligned with that of the banks.[399]

199. Mutual guarantee schemes are usually established by independent MSEs or their representative associations for the purpose of providing guarantees only to their members.[400] They often take the legal form of cooperatives and are governed by the relevant domestic legislation. When the schemes are directly established by the MSEs, these latter contribute to capital formation, participate in decision-making and take joint responsibility for outstanding credits. When business representative associations establish the scheme, they are responsible for its operation.[401] Although they are largely funded from membership fees, in certain countries mutual guarantee schemes operate with some form of State support.[402]

200. Financial institutions may find lending under mutual guarantee schemes profitable since risk assessment and follow-up on loan repayment may be facilitated by the entity overseeing the mutual guarantee scheme. This may considerably lower the financial institution's administrative costs. On the demand side, borrowing through a mutual guarantee scheme may enhance access to credit for viable MSEs since mutual guarantee schemes may be better equipped to assess their loan applications than public credit guarantee schemes. In addition, due to their bargaining

[396] See https://blogs.worldbank.org/psd/protection-reallocation-public-credit-guarantee-schemes-post-pandemic-world.
[397] For example, Chile. See IMF, Special Series on COVID-19 (supra, footnote 367), p. 5.
[398] Ibid.
[399] GIZ, SMEs' Credit Guarantee Schemes in Developing and Emerging Economies, 2014, p. 22.
[400] Ibid., p. 15.
[401] L. Cusmano, SME and Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in supporting finance for small and medium-sized enterprises, in OECD SME and Entrepreneurship Papers No. 1, 2013, p. 24.
[402] OECD, Credit Guarantee Schemes (supra, footnote 347), pp. 8–9.

position, mutual guarantee schemes can negotiate with lending financial institutions lower loan interest rates than individual MSEs.

201. There are, however, challenges in the operation of mutual guarantee schemes that may affect their long-term sustainability. In particular, high level of fragmentation, as most of such schemes serve a limited range of businesses; a low degree of economies of scale in the provision of guarantees, with relatively high operational costs; and high risk exposure, due to their limited geographic and sectoral coverage. In several countries, these challenges have triggered mergers or consolidations of different mutual guarantee schemes to reduce the cost of service and broaden the offer of guarantee instruments. In turn, this has also led to an upgrade of the technical competences of the entities overseeing the schemes and of their skills and strategies.[403]

(c) International schemes for credit guarantees

202. International assistance to set up and operate credit guarantee schemes may be needed in countries where they do not exist (due to lack of resources or in fragile and conflict-affected countries) or previous similar schemes did not succeed in the past and need to be re-oriented. Several international or regional organizations, including global and regional development banks (e.g. the World Bank, [404] the Asian Development Bank, [405] the African Development Bank), have thus launched international credit guarantee schemes in partnerships with a local entity, whether a public authority (e.g. a ministry), a financial institution, a private association or an NGO. Among the international organizations, it can be noted that UNDP[406] and the United Nations Capital Development Fund are engaged in the promotion of international guarantee schemes either in cooperation with national governments or with development banks. There are also privately funded credit guarantee schemes which operate on a regional or international level, such as those administered by the Grameen Foundation which provides assistance to local and regional microfinance institutions and other similar organizations.

203. International credit guarantee schemes are usually established in conjunction with technical assistance packages in order to facilitate their design and implementation.[407] They can have different goals, such as support the development of MSEs in general [408] or of specific groups of entrepreneurs (e.g. women, youth, minority groups etc.) or of MSEs working in specific sectors (e.g. digital or rural). [409]

2. Measures to facilitate the assessment of MSMEs' creditworthiness[410,411]

204. The crucial element of any lending agreement is the financer's decision on whether or not to extend credit to the borrower. Prudent management requires that

[403] L. Cusmano, SME and Entrepreneurship Financing (supra, footnote 401), pp. 67–68.
[404] See www.worldbank.org/en/topic/smefinance.
[405] See for example "ADB to Provide Local Currency Lending to Support MSMEs Growth in Kazakhstan | Asian Development Bank".
[406] For example, UNDP has supported the Ministry of Tourism, Commerce, and Industry (MTCI) and National Commercial Bank of Timor-Leste to establish a loan guarantee facility for MSMEs in need of financial assistance.
[407] A. Green (2003), Credit Guarantee Schemes for Small Enterprises – An Effective Instrument to Private Sector-led Growth, p. 19.
[408] For example, the African Guarantee Fund (AGF), created under the leadership of the African Development Bank, is aimed at boosting access to finance for SMEs. See www.iadb.org/en/idb-finance/guarantees.
[409] See, for example, the USAID and Development Finance Corporation (DFC) programme in Zambia, where they partner with three different banks to provide guaranteed loans across different sectors and purposes, www.usaid.gov/documents/development-finance-corporation.
[410] The secretariat has revised the title of the section to indicate a broader focus on measures to assess MSE creditworthiness, as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 79).
[411] In keeping with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 79), the secretariat has implemented editorial amendments in the section to avoid any prescriptive approach.

financers properly assess the borrower's creditworthiness, i.e. level of risk, capacity and willingness to repay the loan. This may pose difficulties in the case of large companies, for which details on the company's commercial performance, financial statements, exposure to financial risks may be easily available. In turn, it may become demanding and more expensive (compared to the value of the loan) with regard to MSMEs, in particular MSEs and start-ups (to which this section mainly refers), whose data may be inadequate or unreliable, if at all available.

205. Because of this information asymmetry, financers are often more reluctant to lend to MSEs than to bigger companies. This, in turn, reduces MSEs' options to access credit as it can translate into a request for collateral assets (which the MSE may not have) or personal guarantees, in the offer of inadequate services or products or even in adverse selection. In order to minimize information asymmetries, the G20 and OECD recommend developing information infrastructures for credit risk assessment that support an accurate evaluation of the risk in financing small businesses and, to the extent possible, to standardize credit risk information and make it accessible to relevant market participants and policymakers, including at the international level in order to foster small businesses' cross-border activities and participation in global value chains.[412,413] In certain countries, the legal and regulatory framework has created information-sharing mechanisms consisting of multiple and complementary sources through which financers must gather information on a potential borrower before extending credit. This ensures that financers can properly assess the MSE creditworthiness and any potential credit risk. The tools presented in the following paragraphs are an example of how information asymmetry can be reduced.[414]

(a) Credit reporting

206. Credit reporting systems, where they are in place, play a key role in addressing the problem of information asymmetry as they enable the collection and distribution of financial information on potential borrowers thus allowing financers to learn more about the MSE characteristics, past behaviour, repayment history and current debt exposure. This can reduce the cost for financers to conduct due diligence and result in lower interest rates for MSEs.[415] Credit reporting, however, may be less relevant in assessing the creditworthiness of the MSE in the context of relationship lending where interactions between the financer and the MSE over time allows the former to collect the information necessary to assess the creditworthiness of the latter. In that case, credit reporting may rather play a supplementary role to fill any residual gaps.

207. Credit reporting providers can be either public entities or privately owned companies: the latter tend to cater to the information requirements of financers, 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 operates 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).[416]

208. The International Committee on Credit Reporting (ICCR) has noted the absence in many countries of specific laws addressing commercial credit reporting. 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, since requirements might be different. For example, information needed to assess the risk of commercial transactions generally includes significantly more data

[412] G20/OECD High Level Principles on SME Financing, 2015, p. 6.
[413] The secretariat has relocated here this sentence, with editorial adjustments, from the section on Transparency (para. 229 of A/CN.9/WG.I/WP.126) for improved consistency of the text.
[414] The secretariat has redrafted the opening of the section (paras. 193 and 194 of A/CN.9/WG.I/WP.126) for improved clarity.
[415] For example, in Kenya the launch of a credit reporting service has helped reduce interest rates, collateral requirements, and default rates for loans at commercial banks.
[416] World Bank, General Principles for Credit Reporting, 2011, p. 7.

concerning payment and financial performance than is required for individual consumers.[417] Further, 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 MSEs.[418]

209. 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 MSEs' credit reporting as well.[419] In this regard, this section will briefly discuss three aspects: (i) MSEs' reporting obligations; (ii) access to credit reporting services; and (iii) data quality. As a preliminary consideration, it should be noted that an effective credit reporting system for MSEs should recognize that women entrepreneurs often face more obstacles than men's to build their credit history as they may lack the identification documents required by the credit reporting providers, or they may not have an account with a formal financial institution or hold a credit card, which may prevent them from being considered by the credit reporting providers. It would thus be important that the legal and regulatory framework include provisions that address those matters and permit women to build their credit history.[420]

(i) Reporting obligations

210. There seem to be no standard requirements across jurisdictions for MSEs to submit financial information to public agencies and other entities. In many countries there are no reporting obligations, and in others the information required is often not sufficient for a robust assessment of the business creditworthiness. While this may contribute to the formation and initial growth of MSEs since it reduces some of the administrative burdens they face, it does not facilitate credit reporting and thus access to credit. In addition, absence of reporting obligations may prevent small businesses from engaging in good financial reporting practices which would be in their interest as it would provide evidence of their accountability and transparency of their operations and help them attract investments as they further progress. Moreover, when MSEs 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.[421] Recognizing that publicly available information (e.g. on working capital or capital needs), may help strengthen their market reputation, both the UNCITRAL LLE Guide and the UNCITRAL Business Registry Guide (see paras. 166 and 170) advise States to encourage small businesses' voluntary submission of financial information to the relevant authorities.[422]

211. 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 would encourage and greatly facilitate MSEs' financial reporting. Several MSEs 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 information. To ensure equal consideration to the needs of creditors, it would also be important for the legal framework to balance the right of MSEs to protect their know-how with that of their creditors to collect, analyse and distribute credit-related data.[423]

[417] Ibid., p. 13.
[418] World Bank, ICCR, Facilitating SME financing (supra, footnote 35), p. 20.
[419] Ibid.
[420] N. Almodóvar-Reteguis, K. Kushnir, and T.Meilland, in Women, Business and the law, Mapping the Legal Gender Gap in Using Property and Building Credit, p. 6.
[421] World Bank, ICCR, Facilitating SME financing (supra, footnote 35), p. 20.
[422] See UNCITRAL Legislative Guide on Key Principles of a Business Registry (2018), para. 155 and UNCITRAL Legislative Guide on Limited Liability Enterprises (2021), para. 142. In keeping with deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 80), the secretariat has highlighted the importance of encouraging voluntary financial disclosure by small businesses consistent with the previous legislative texts prepared by the Working Group.
[423] World Bank, ICCR, Facilitating SME financing (supra, footnote 35), p. 21.

(ii) Access to credit reporting services

212. Public and private credit reporting providers serve different beneficiaries. Therefore different rules may govern access to their services. However, as noted by the World Bank, the legal and regulatory framework supporting credit reporting should provide that data access responds to impartial rules so that all users of the private or public service have access to information under the same conditions established for that type of service (e.g. access fees or access to the same information).[424] There may be exceptions to this principle of non-discrimination due to the purpose of the credit reporting provider. For example, some 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.[425]

(iii) Data quality

213. High data quality is the cornerstone of an effective credit reporting system: it means that 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.[426] Inaccurate data can result in unjustified loan denials, higher borrowing costs, and other unwanted consequences for MSEs, data providers (e.g. 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. 216), and how the credit reporting providers process the raw data received in order to convert them into the final products that will be accessed by the financers.[427]

214. 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[428] 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.[429] For effectiveness of the credit reporting system, these requirements should be applicable to both data and credit reporting providers.

215. Accuracy and reliability of the information provided by the MSEs when interacting with the data providers contributes to data quality. The legislative and regulatory framework could thus allow MSEs to access their own data in order to correct or update it or dispute its accuracy and completeness and have those complaints investigated and any errors corrected.[430]

(b) Public agencies' records as a complementary source of relevant information[431]

216. The most common sources of data on MSEs' creditworthiness are banks and other non-bank[432] financial institutions that are small businesses' most common creditors. While these entities are usually required by law or regulation to provide the information to the public credit reporting providers, there seem to be no laws mandating disclosure of information to private credit reporting providers[433] or

[424] World Bank, General Principles (supra, footnote 416), p. 42.
[425] Ibid., p. 35.
[426] See General Principle 1 in World Bank, General Principles (supra, footnote 416), p. 25.
[427] Ibid., p. 26.
[428] OECD, Discussion Paper on Credit Information Sharing, p. 12.
[429] World Bank, General Principles (supra, footnote 416), p. 37.
[430] OECD, Discussion Paper on Credit Information Sharing (supra, footnote 428), p. 12.
[431] The secretariat has revised the title of this subsection for improved consistency with the focus of the section.
[432] The secretariat has replaced the term "regulated" with "non-bank" as requested by the Working Group at its thirty-seventh session (A/CN.9.1090, para. 81).
[433] In practice, some banks may provide private credit reporting providers with information on a voluntary basis, others may do so on a limited basis only (for example, not allowing the private credit reporting provider to disclose the name of the bank or the details of the loan), and still

non-traditional financers (e.g. business angel investors) that might have an interest in extending credit to MSEs. Other potential sources of data and information can include commercial entities such as factoring and leasing companies and non-bank financial institutions, as well as trade creditors. It seems however that none of these entities provide as much data as expected.[434]

217. In order to offset the scarce or inadequate information from all those sources, public sector agencies, such as taxation and social security or the business registry, may represent an additional and valuable source of information. Among others, they may provide official identification data for MSEs, data that contribute to determining the MSE's behaviour (e.g. bankruptcy information) and financial information.[435] In countries where they are established, security rights registries also play a significant role as they provide information on the potential existence of a security right on assets that the MSMEs may use to secure a loan.

218. However, accessing the information maintained by public agencies may be difficult due to legal and practical issues. First, not all countries may have laws or regulations that facilitate access to that information. Moreover, in some cases, some or all of the data maintained by the public agency may be considered confidential and access might be restricted.[436] Alternatively, existing laws or regulations may not clarify whether entities or individuals other than the data subjects may access the data maintained in the public agencies and reuse it for commercial purposes. Finally, laws or regulations may simply not require public agencies to share the data they maintain. To increase the sources of information available to financers, it is thus important for the domestic legal framework to permit and facilitate the use of information held by public authorities.

219. In addition to an inadequate legal framework, practical impediments may also affect the collection of data from public agencies. For example, public agencies often lack sufficient human and financial resources to maintain the data stored in their records in as current a state as possible, which results in outdated data of very little use for the purposes of credit reporting.[437] As it may not be feasible for many States to adequately support all public agencies that collect data relevant for assessing MSEs' creditworthiness, resources could be prioritized to first assist those agencies (e.g. tax authorities) whose records are key to carry out such evaluation.

(c) Alternative data

220. When MSEs or their clients use cloud-based services or their mobile or smartphones, engage in social media, sell or buy on electronic commerce platforms, ship packages,[438] make e-payments, conclude an online transaction with their bank or manage their receivables, payables, and record-keeping online, they create digital footprints.[439] In recent years, such footprints, defined as alternative data,[440] have

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others may refuse to share information because of bank secrecy obligations. See World Bank, ICCR, Facilitating SME financing (supra, footnote 35), p. 18.

[434] For example, in the United States it is estimated that less than 50 per cent of business to business suppliers share trade credit information with commercial credit information companies. Ibid.

[435] Ibid., p. 19.

[436] Ibid.

[437] Ibid., p. 21.

[438] For example a US-based FinTech company uses, among other sources of information, the shipping records of international freight forwarders to assess the risk and creditworthiness of businesses seeking a loan. See GPFI, Alternative Data Transforming SME Finance, 2017, p. 12.

[439] OECD, Discussion Paper on Credit Information Sharing (supra, footnote 428), p. 12.

[440] 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.

gained increased relevance in credit reporting.[441] This trend towards 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".[442] Alternative data can also prove beneficial for financers[443] as it allows a more comprehensive assessment of the business's creditworthiness, which 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 scoring[444] for the business. Moreover, since the data comes from digital sources, it makes it easier to monitor the MSE conditions, detect fraud and adopt the relevant risk mitigation measures. This may also encourage positive financial behaviours of the MSE.[445] Further, since alternative data is usually generated by third-party providers, they may be more reliable than asset value information and financial statements provided by the MSE, which also contributes to reduce the lending risk of financers.[446]

221. However, in many countries the absence of a strong legal and regulatory framework may pose obstacles to the effective use of alternative data which may result, for example, in data inaccuracies, privacy and personal data protection[447] and intellectual property issues. For example, social media data is often collected without the MSE's consent which may result in their unlawful 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 MSE's owner.[448] International expert forums[449] suggest that in order to support an effective and transparent use of alternative data countries may reform their laws 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 international standards); ensure their compliance with credit laws or regulations, and avoid potential discrimination.[450]

222. Given the flow of alternative data across borders, issues of how data is treated in different countries may also easily arise. There may be differences in the specific data that can be collected for lending purposes and shared cross-border, or difficulty in identifying MSEs in different countries due to inconsistent or non-standardized identification systems. For example, international experts forums recommend that States cooperate with relevant international bodies to harmonize different aspects of their legal regimes applicable to cross-border data flow[451] including the adoption of a global unique identifier for MSEs (and medium-sized enterprises) that could greatly facilitate cross-border data sharing.[452] So far as the collection of alternative data involves the identification of MSEs and the flow of data between the credit reporting

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[441] For example, a small business digital lending platform uses alternative data such as business volume, number of UPS packages a business sends and receives over time, or social media activity to underwrite MSMEs' loans. See https://yabx.co/2020/08/04/use-of-alternative-data-to-revolutionize-digital-sme-lending/. As another example, in Chile a major credit-scoring agency has partnered with a start-up in order to use cell phone data to provide a "Predictor Inclusion Score" for those without credit history. See World Bank, Credit Reporting Knowledge Guide 2019, p. 110.

[442] GPFI, Use of Alternative Data (supra, footnote 440), p. 5.

[443] See for example www.datappeal.io/5-benefits-of-alternative-data-for-banks-and-financial-institutions-from-enriched-credit-scoring-to-lead-qualification/.

[444] Credit scoring is a statistical analysis to determine the creditworthiness of individual consumer or small business borrowers. Its results determine financers' decision on whether to extend or deny credit.

[445] GPFI, Use of Alternative Data (supra, footnote 440), p. 5.

[446] See Hong Kong Monetary Authority, Alternative Credit Scoring of Micro-, Small and Medium-sized Enterprises, p. 29.

[447] See for instance the Council of Europe Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data (ETS No. 108), 1985, available at https://www.coe.int/en/web/conventions/full-list?module=treaty-detail&treatynum=108.

[448] GPFI, Use of Alternative Data (supra, footnote 440), p. 6.

[449] Ibid.

[450] The secretariat has revised this paragraph (para. 206 of A/CN.9/WG.I/WP.126) for improved clarity.

[451] GPFI, Use of Alternative Data (supra, footnote 440), p. 26.

[452] Ibid.

providers, and the financers, the work of UNCITRAL on legal issues related to the digital economy, notably on identity management and trust services and on data transactions, may be relevant. Work of UNCTAD on the role and value of digital data in electronic commerce and its advocacy efforts for a system of global data governance may also contribute to enhance MSEs' access to credit.[453,454]

Note to the Working Group: *The secretariat will further elaborate on the topic of measures to assess MSMEs' creditworthiness (including possible reorganization of the section) in the next iteration of the draft Guide.*

3. Restructuring support for MSMEs in financial distress

223. When facing financial difficulties, MSMEs often do not have the resources to cope with high restructuring costs (including seeking professional advice), although the use of technology (e.g. artificial intelligence and big data) may potentially reduce restructuring costs.[455] 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. If an efficient restructuring framework is adopted, financers might be more likely to extend credit to MSMEs as such framework could reduce the number of unnecessary liquidations of viable MSMEs, 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 avoiding the accumulation of such loans on banks' balance sheets. The high level of non-performing loans in some parts of the banking sector limits banks' capacity to offer loans to MSMEs.

Mechanisms under insolvency law

224. In addition to building a general efficient support system for MSMEs, the topic of restructuring support seems particularly relevant in the context of new financing, informal restructuring and early rescue mechanisms, which are dealt with in the *UNCITRAL Legislative Guide on Insolvency Law for Micro- and Small Enterprises* (the *"Legislative Guide"*).[456] The *Legislative Guide* recommends facilitating and providing incentives for new finance to be obtained by those businesses 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.[457]

225. 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 (e.g. tax incentives, exempt transactions arising from informal debt restructuring negotiations from avoidance proceedings).[458] They are also encouraged to identify and remove

[453] See for example the work of the Intergovernmental Group of Experts on E-commerce and the Digital Economy at UNCTAD (https://unctad.org/meetings-search?f%5B0%5D=product%3A335 instance) or the Digital Economy reports series (https://unctad.org/webflyer/digital-economy-report-2021). The secretariat has added this reference to UNCTAD work as suggested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 82).

[454] The secretariat has added reference to the work of UNCITRAL Working Group IV (Electronic commerce) and of UNCTAD as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 82).

[455] According to some studies, the costs of financial distress represent 10 per cent to 20 per cent of the market value of a small business. See A. Gurrea-Martinez, Implementing an Insolvency Framework for Micro and Small Firms, 2020, footnote 49.

[456] *Official Records of the General Assembly, Seventy-sixth Session, Supplement No. 17* (A/76/17), annex II.

[457] Ibid., recommendation 107.

[458] Ibid., recommendation 105 and related commentary as contained in A/CN.9/WG.V/WP.174, paras. 408–410.

disincentives for the use of informal debt restructuring negotiations (e.g. an obligation to file for formal insolvency within a certain period after the occurrence of certain events, insolvency law provisions on avoidance of transactions concluded during a certain period before filing for insolvency).[459] Furthermore, institutional support with the use of informal debt restructuring negotiations (e.g. involvement of a competent public or private body to facilitate negotiations) is also recommended.[460]

226. Further, the *Legislative Guide* envisage establishing mechanisms for providing early signals of financial distress to MSEs, increasing financial and business management literacy among MSE managers and owners and promoting their access to professional advice.[461] The *Legislative Guide* highlights three mechanisms that may be of particular assistance to ensure early rescue of MSEs. 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 MSEs to improve their financial and business management literacy and skills (see also para. 261). Lastly, MSEs' 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.[462]

4. Procedures and mechanisms for resolving disputes on access to credit

227. The existence of an effective dispute resolution system is critical in determining the decision of MSMEs[463] to borrow and of financial service providers, including credit reporting providers, to extend their services to the small businesses. Disputes may arise about excessive fees or interests, use of specific products (e.g. credit cards, mortgages etc.), rejections of loan requests or poor financial advice.[464] In the relation between the small businesses and credit reporting providers (or the data providers) complaints may range from requesting to rectify errors or adverse decisions based on inaccurate data, to deleting certain data or to claiming compensation for any damage incurred.

228. In many countries settling financial disputes in court may not be a viable option for most MSMEs, particularly MSEs, since this may be too complex and usually more expensive than the loan value and MSMEs may often lack the necessary financial means for lengthy processes as well as the skills required to deal with their difficulties (mature medium-sized enterprises may have the necessary skills and financial resources). The existence of redress mechanisms outside the court system, which can solve such disputes effectively and at low cost, may thus encourage MSMEs to obtain a loan from a financial service institution. Efficient redress mechanisms would be beneficial for financial service providers as well. Financial institutions are generally more willing to lend to MSMEs ex ante when adequate redress mechanisms are put in place to allow them to control borrower risk and recover the loan in the event of default, thereby providing better creditor protection. Financial institutions' decisions to lend are often affected by several aspects of the judicial system including (i) the number of procedural steps required to enforce a contract and (ii) the time and costs for resolving a dispute in court. A cumbersome judicial procedure requires additional effort and resources to recover the credit and it may even result in a financial loss for the financial institution in case of the MSME's default, given the low amount of the credit usually granted to the MSME. The length of dispute resolution often affects the cost of lending for the financial institutions and their disposition to lend since fast

[459] Ibid., recommendation 104 and related commentary as contained in A/CN.9/WG.V/WP.174, para. 406.
[460] Ibid., recommendation 106 and related commentary as contained in A/CN.9/WG.V/WP.174, paras. 411–414.
[461] Ibid., recommendation 103.
[462] Ibid., recommendation 103 and related commentary as contained in A/CN.9/WG.V/WP.174, paras. 399–403.
[463] Medium-sized enterprises and MSEs often face the same problems in relation to disputes with financers. This section thus mainly refers to both groups (using the acronym MSMEs), while highlighting certain redress mechanisms that are mainly accessible to MSEs.
[464] CGAP, Financial Access, 2010, p. 32.

resolution allows a faster loan recovery. Finally, high costs of court proceedings and attorney fees make the providers of financial services more reluctant to grant small loans to MSMEs. As the Consultative Group to Assist the Poor (CGAP) has noted, availability of redress mechanisms for financial disputes thus is not just a matter of fairness to address the power imbalance between MSMEs and financial service providers, but it is beneficial to the credit industry overall as it enhances its sustainability.[465]

a. Criteria for effective dispute resolution procedures and mechanisms

229. To solve disputes between MSMEs and financial service providers in an efficient way, many States apply a dual-track dispute resolution system, as in other types of disputes between service providers and customers. The system is based on internal complaints handling procedures implemented by the financial providers and external redress mechanisms that address those complaints that are not resolved through the internal procedures. Best practices recommend that both types of mechanisms should be accessible at a reasonable cost, independent, fair, accountable, timely and efficient and should not impose burdens on the MSMEs.[466,467] It should be noted that while internal complaint handling mechanisms are available to medium-sized enterprises as well, certain external redress mechanisms may not be available to them but to MSEs only (see para. 234).

(a) Internal complaint handling procedures

230. Internal complaint handling procedures must usually comply with minimum standards such as those requiring the provision of clear information on the grounds the small businesses can submit a complaint and through which channels. Adequate channels (including working hours) for submitting the complaints should thus be in place and should address the needs of remotely located MSMEs too. Specially tailored channels should be available for selected groups of entrepreneurs, such as illiterate ones or entrepreneurs who speak only local dialects.[468] Receipt of the complaints by the financial service provider should be acknowledged in a durable medium, for example in writing or in another form that the MSME can store. The financial service providers should also 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 (e.g. a financial ombudsman, a mediator etc.). If external redress mechanisms exist, throughout their complaints-handling process the small businesses should be informed about the possibility to seek redress through such schemes.[469]

(b) External redress mechanisms

231. If the entrepreneurs are unsatisfied with the decision resulting from the internal complaints system they should have the opportunity to appeal to external redress mechanisms such as the financial ombudsman services, 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.[470] For example, the financial ombudsman not only investigates and resolves disputes between financers and MSMEs, but can also provide business support to prevent disputes through initiatives ranging from regular communications

[465] Ibid., p. 31.
[466] OECD, G20 High Level Principles on Financial Consumer protection (2011), p. 7.
[467] The secretariat has deleted the penultimate sentence in this paragraph (para. 215 of A/CN.9/WG.I/WP.126) for improved consistency of the text.
[468] World Bank, Good Practices for Financial Consumer Protection, 2017, pp. 49–50. The Good Practices is a compilation drawing on successful policy, legislative and regulatory initiatives around the world that consolidates, complements and expands international principles and guidance on that matter – such as the G20 High-Level Principles on Financial Consumer Protection. The Good Practices can also apply to MSEs since those businesses usually face the same challenges as individual consumers and require the same basic protection.
[469] Ibid.
[470] CGAP, Financial Access (supra, footnote 464), p. 31.

to advisory groups or ad hoc meetings. On the other hand, ombudsman decisions are often not binding on the parties and the ombudsman may not provide a quick solution to more complex claims. There might also be time limits affecting the possibility for a small business to bring a complaint to the ombudsman.

232. When the financer and MSME wish to minimize conflict, mediation may be a more appropriate mechanism to help them preserve their relationship. Mediation is informal and flexible, quicker than litigation and gives parties the chance to understand each other's point of view and to craft tailor-made solutions. However, parties can terminate the mediation process at any time, thus jeopardizing the possibility to reach an amicable settlement. Moreover, like the ombudsman, the mediator does not have the power to impose a binding decision on the parties. The *UNCITRAL Model Law on International Commercial Mediation and International Settlement Agreements Resulting from Mediation* (2018) and the *United Nations Convention on International Settlement Agreements Resulting from Mediation* (New York 2018) (the "*Singapore Convention on Mediation*") provide internationally harmonized rules, also applicable in the context of financers' and MSMEs' disputes, to assist States in reforming and modernizing their laws on mediation. In several countries ad hoc banking mediation services exist, which can either offer specific services for small businesses, or be open to businesses of all sizes, including MSMEs, and legal status.[471] Banking mediation may be particularly suitable for small businesses since it does not only foster amicable settlement of disputes with financers, but also facilitates mutual exchange of financial information and strengthens MSMEs' capacity to supply adequate information in a financial transaction.[472] As it has been noted, the benefits of banking mediation often extend beyond the individual loan case assisted.[473,474]

233. If the dispute cannot be resolved amicably and requires a more formal resolution, arbitration may be a preferable choice to litigation, particularly for small loan disputes. In certain countries, mandatory arbitration clauses to solve disputes arising between financers and MSMEs are included in the loan agreement, although this might limit MSMEs relief options.[475] While arbitration is less formal than court proceedings (thus less intimidating for a small business), follows simpler procedural rules adaptable to the needs of the parties and is flexible in scheduling and location of the hearings, it is however an adversarial proceeding which requires lawyers and sometimes other experts. It can thus be an expensive and a non-viable option for an MSME, in particular given the low value of the loan. Moreover, recourse against an arbitral award can usually be made only in court. UNCITRAL legislative and contractual texts on International Commercial Arbitration provide a comprehensive set of rules to assist (i) States in strengthening the domestic arbitration regime, and (ii) arbitral institutions in drafting rules for arbitration proceedings. To increase MSMEs' access to dispute resolution mechanisms, regional organizations and States are increasingly supporting the use of online dispute resolution mechanisms. They 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 Disputes with the scope of helping small businesses to 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

[471] For example in France, where a banking mediation service operates under the supervision of the National Bank. See https://mediateur-credit.banque-france.fr/.

[472] See for example the *service de médiation crédit bancaire* in Belgium. Further information available at: Conseils et médiation: améliorez vos perspectives d'accès au crédit, available at www.1890.be/solution/mediation-credit.

[473] OECD (authored by L. Cusmano), Credit mediation for SMEs, 2013, p. 29.

[474] The secretariat has expanded the discussion on banking mediation in line with deliberations of the Working Group at its thirty-seventh session that emphasis could be put on mediation and special procedures for financial consumers (A/CN.9/1090, para. 84).

[475] World Bank, Good Practices (supra, footnote 468), p. 52.

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) may provide guidance to States, ODR platforms and administrators regarding how to develop and use such mechanisms.[476]

234. It should be noted that in many countries certain external redress mechanisms, for example the ombudsman,[477] serve both individual consumers and MSEs as they usually face the same challenges and require the same protection in their disputes with banks, their subsidiaries and other financial intermediaries.[478] In order to determine the eligibility of a business to access those services, States may use criteria such as the number of employees or its annual turnover that are set at a level which de facto excludes medium-sized enterprises.

235. In accordance with good practices, external redress mechanisms are usually established by industry or associations or by law.[479] Regardless of whether they have a statutory or industry-based nature, the mechanisms should follow clear minimum standards in accordance with the law or regulation and be monitored by an independent body that is accountable to the government or the regulatory authority.[480] Further, it is important that they also operate in a cost-efficient way in order to minimize any financial burden on their users, in particular the small businesses, as well as taxpayers in general if they are public entities. Cost-efficiency can be achieved through regular assessment of available human and financial resources to plan in advance their allocation and reduce any potential misuse. Regular monitoring of case handling permits to improve procedures and their user-friendliness. Supporting the redress mechanisms through public funds, public-private partnerships or requiring financial institutions to meet the cost of the services can ensure their sustainability[481] and at the same time increase MSME's accessibility (see para. 239).[482]

236. As noted earlier (paras. 231 and 232), an important aspect of these mechanisms is whether they can render binding decisions as some of them (e.g. ombudsman or mediation) may rely more on voluntary compliance although reputational risks may often pressure the financial entities to comply. For example, if a financial institution does not comply with the decisions of the relevant redress mechanism a notice of non-fulfilment may be made public.[483] To ensure protection of the small business, it would be important that the decisions of the external redress mechanism are binding

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[476] As requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 84), the secretariat has added: (i) a discussion on the advantages and disadvantages of the redress mechanisms; and (ii) reference to the UNCITRAL tests on dispute settlement and the APEC Collaborative Framework for Online Dispute Resolution of Cross-Border Business to Business Disputes. For improved consistency, the secretariat has also relocated here the discussion on online-dispute resolution mechanisms from the subsection on "Resolving disputes between MSMEs and providers of FinTech products" (paras. 227 and 228 of A/CN.9/WG.I/WP.126).

[477] For example, the Office of the Banking Services Ombudsman in Trinidad and Tobago (www.ofso.org.tt/index.php/about-us/) or the Financial Ombudsman Service in the United Kingdom or the Australian Financial Complaints Authority (AFCA). AFCA was established in 2018 to replace the Financial Ombudsman Service and the Credit and Investments Ombudsman. Further information available at: www.afca.org.au.

[478] The secretariat has deleted the phrase "other similar offices" (para. 218 of A/CN.9/WG.I/WP.126) for improved clarity of the text.

[479] By way of example, the World Bank cites the microfinance or industry associations' schemes such as MFIN and Sa-Dhan in India, ALAFIA in Benin and AMFIU in Uganda. See World Bank, Good Practices (supra, footnote 468), p. 52.

[480] World Bank, Good Practices (supra, footnote 468), p. 51.

[481] In certain countries, for example, the mechanisms are supported through public funds allocated either by the central government (e.g. Lithuania) or a specific authority such as a central bank or a financial regulator (e.g. in Spain and Poland). In other countries, the mechanisms are supported by the industry or the members of the alternative dispute resolution scheme (e.g. Armenia, Australia, Canada, Trinidad and Tobago and the United Kingdom). See World Bank, Good Practices (supra, footnote 468), p. 52.

[482] The secretariat has added this discussion on cost-efficiency of the redress mechanisms and how to minimize the cost for the MSMEs as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 85).

[483] See the *arbitro bancario finanziario* in Italy in A/CN.9/780, para. 22. The term "arbitro bancario finanziario" can be roughly translated as "banking financial arbitrator".

on financial entities[484] and that financial entities are not allowed to appeal against those decisions, as this could easily result in costly and lengthy processes in court where small businesses will be highly disadvantaged.[485] There are, however, examples of countries where decisions can be appealed by both parties, although appeals may be allowed only in a few circumstances, such as if procedural rules were violated, or the prejudice of the mediator was demonstrated.[486]

237. Other key features to consider for the efficient functioning of the external redress mechanisms are their independence and the impartiality of their decision-making process which contribute to build trust in their operation. For example, the International Network of Financial Services Ombudsman Schemes notes that the independence should be established in the law or in a constitution that is approved by a public entity, the parties should not be able to influence the service directly or indirectly and the ombudsman or the members of the decision-making panels should have not worked in previous years in a financial entity covered by the service.[487] The mechanisms' independence and the impartiality of their decision-making process should also be preserved from any undue influence of their sources of funding, regardless of whether they are public or private or a combination of both. It should be noted that in certain cases (e.g. errors or inaccuracy of data maintained in a credit registry) quantifying damages and the resultant compensation might be difficult to do in practice and the law or regulation could provide guidance on this matter.

238. The principles of accessibility, effectiveness, fairness and transparency and accountability should guide the activities of the external redress mechanisms. The following paragraphs provide a short account of how they could be implemented in their organization and operation.

(c) Accessibility

239. The law should ensure that the mechanisms provide information in a plain and understandable language, users have easy access to the mechanisms, both online and face to face, and can file complaints through different media. In addition, complainants should not be required to pay any fees (or they should pay only minimal fees), since this may discourage them from using the service.[488] In this respect, it could be considered whether fees could be used as a disincentive to prevent frivolous complaints. It seems, however, that granting the authority to the external redress mechanism to reject complaints that are frivolous, vexatious or misconceived may be more effective.[489]

(d) Effectiveness

240. It would also be desirable that the law include a clear definition of what constitutes a complaint and clarify that it will be dealt with no delay through a flexible and informal process for which the parties will not need a lawyer or an advisor. Further, the parties should be notified when documents are received by the redress mechanism and the mechanism's decisions should be taken and made available within a specified time.

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[484] For example, in the Russian Federation, the Federal Law 4 June 2018 #123-FZ lists organizations that are obliged to comply with the decisions of the commissioner for the rights of consumers of financial services (also including MSMEs). If those organizations are non-compliant, the decision of the Commissioner can be enforced by the court executive authorities.

[485] World Bank, Good Practices (supra, footnote 468), p. 52.

[486] For example, Malta and Armenia. As to limitations on the scope of an appeal see art. 17. The Republic of Armenia Law on Financial System Mediator, available at: www.fsm.am/media/2398/law-on-fsm.pdf.

[487] Network of Financial Services Ombudsman Schemes, Effective approaches to fundamental principles, 2014, p. 2.

[488] See World Bank, Good Practices (supra, footnote 468), p. 52.

[489] For example, Australia, Armenia and Malta.

(e) Fairness

241. It is important for States to ensure that the procedures of the redress mechanism allow the parties to receive all documents submitted, to express their arguments and respond to the other party's arguments, as well as to have access to any statements made and opinions given by experts and be able to comment on them.

(f) Transparency and accountability

242. Finally, it would be desirable to ensure that the redress mechanisms inform the parties of their scope, the types of disputes they are competent to deal with, including any threshold if applicable, the procedural rules governing their activities and the type of rules they may use in their dispute resolution activity and any requirement the parties may have to meet before the procedure can be instituted.

b. Resolving disputes between MSMEs and providers of FinTech products

243. It should be noted that with the increased use of FinTech services by MSMEs, disputes between MSMEs and FinTech providers, for example on data ownership, lack of transparency in contract terms or contract enforceability, have also rapidly increased. Owing to the fact that in many countries FinTech providers are not regulated by financial sector authorities and do not have to comply with the same regulations as banks may result in the absence of internal complaint handling procedures to address MSMEs' complaints.[490] Moreover, not all countries may have external redress mechanisms where it is possible to lodge a complaint against FinTech providers[491] and, as noted above (see para. 228), settling financial disputes in court may not be a viable option for micro and small enterprises in many countries.

244. In order to provide some protection to MSME users of FinTech services, in some countries[492] the FinTech industry has thus developed codes of conducts addressing irresponsible providers' behaviours. Although those tools cannot replace an appropriate redress system, they can prompt FinTech providers to improve their protection practices for the users of their services. States seeking to strength the efficiency of the codes of conduct may consider requiring mandatory membership in the industry associations that have issued them and strong self-enforcement mechanisms.[493] As a general measure, it would however be advisable to ensure that the requirement of establishing internal complaints procedures apply equally to all providers of financial products or services, including FinTech, and that external redress mechanisms address complaints concerning all financial service providers.[494] Since several FinTech transactions concern low-value services and products and take place cross-border, it has been suggested that online dispute resolution mechanisms may also be an efficient and effective option to resolve disputes arising out of those transactions (see para. 233).[495]

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[490] Australian Small Business and Family Enterprise Ombudsman, www.asbfeo.gov.au/sites/default/files/2021-11/ASBFEO-fintech-borrowing-guide.pdf.

[491] For example, in Portugal this role is performed by the Central Bank. See OECD, Effective Approaches for Financial Consumer Protection in the Digital Age: FCP Principles 1, 2, 3, 4, 6 and 9, 2019, p. 46. On the contrary, in 2014 the Central Bank of Ireland clarified that since peer-to-peer platforms were not regulated activities, the Financial Services Ombudsman could not investigate complaints concerning those platforms. See World Bank, Consumer Risks in FinTech (supra, footnote 183), p. 78. As noted on page 13, the publication focuses on retail consumers, a category that also includes MSMEs.

[492] For example, Kenya and Indonesia. See World Bank, Consumer Risks in FinTech (supra, footnote 183), p. 68.

[493] Ibid.

[494] See OECD, Effective Approaches for Financial Consumer Protection (supra, footnote 491), p. 45.

[495] S.W. Gumbira, D. Puspitawati, K. Tejomurti, Unefficiency Settlement Of FinTech Lending Disputes And How Legal Framework To Settle It: Indonesia Perspective, in Journal of Contemporary Issues in Business and Government vol. 27, No. 2, 2021, available at: https://www.cibgp.com/article_10434.html.

5. Transparency[496]

245. Transparency is a key feature in the relationship between financers and MSMEs: it contributes to mitigate financers' risks in lending while making 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.

246. Three dimensions of transparency are particularly relevant in the context of access to credit: (i) availability of sufficient information for financers to assess MSMEs' creditworthiness (see paras. 204 to 222); (ii) clear and transparent terms and conditions for credit products and services; and (iii) availability of sufficient information for MSMEs on different means to access credit (see paras. 261 and 264).[497] This section focuses on (ii) and (iii), since the challenges of information asymmetry for financers lending to MSMEs and examples of how to mitigate them are discussed in the section on "Measures to facilitate the assessment of MSMEs' creditworthiness".

247. In most jurisdictions, the rules on the transparency of contractual terms and fair relations with customers generally apply to banking and financial products and services (e.g. current accounts, deposits, loans and payment services). For example, countries may require that the information is disclosed in a prescribed form that may include standardized methods of displaying charges, or that technical terms are explained to the MSMEs in an understandable language or that small print clauses are subject to a user agreement. Such clarity permits MSMEs to make informed decisions and ensures them a certain degree of protection, while minimizing the risks of MSME's misuse of loans. Ensuring clarity of contractual terms and conditions also benefits financers as it helps strengthen their position on the market and attract new customers.[498]

248. The issues of transparency and disclosure of information to MSMEs are of great importance also in relation to non-bank institutions given that in certain countries digital financial service providers that are not regulated (e.g. FinTech companies in several countries) 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.[499] International experts' forums recommend States to adopt a sound legal framework to ensure that information on all those terms and conditions is disclosed clearly and in a way that is understandable to small businesses that may not often have adequate financial literacy.[500] It would be equally important that digital financial service providers disclose information on the technology used to support the operation of the online platform and in particular any significant change in its hardware or software components that may negatively affect the MSME's ability to access its records or perform digital operations.[501]

249. It was also reported that many microfinance institutions price their products in a non-transparent manner, obscuring the true price of loans and confusing clients

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[496] The secretariat has revised this section on transparency consistent with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 88).

[497] The secretariat has moved reference to the G20 and OECD High Level Principles on SME Financing (para. 229 of A/AN.9/WG.I/WP.126) to the section on "Measures to facilitate the assessment of MSMEs' creditworthiness" to avoid redundancies (supra, footnote 413).

[498] The secretariat has split paragraph 230 of A/CN.9/WG.I/WP.126 in two (paras. 247 and 248 above) and has improved the discussion on transparent terms in paragraph 247 by: (i) relocating the second sentence here from para. 257 (para. 237 of A/CN.9/WG.I/WP.126); (ii) adding reference to small print clauses and technical terms; and (iii) including a new sentence on misuse of loans.

[499] GPFI, Promoting digital and innovative SME financing (supra, footnote 27), p. 72.

[500] Ibid., p. 84.

[501] J. Ballard, C. Brennan, C. French, E. Johnson, Exploring the Legal Issues Relevant to Online Small-Business Lending, 2017 available at: https://www.americanbar.org/groups/business_law/publications/blt/2017/08/02_ballard/.

through techniques such as "flat" interest and complex fee structures.[502] Transparent pricing is considered as an essential element in creating an enabling environment for microenterprise: although important for any financing agreement, transparency issues are of most concern to unsophisticated MSME borrowers who cannot afford legal advice.[503] Among other things, international experts' forums recommend that microfinance institutions should be required to adopt standard pricing formulas (with appropriate disclosure standards) as well as standard repayment schedules.[504]

250. Transparency in MSME financing can also be improved through providing MSMEs with easy access to information on suitable sources of financing and adequate means to access them. In certain countries, the problem might be the low level of information available in general; in others, the creation of unnecessary barriers to access available information. For example, information services may charge access fees, or their users may have to register or otherwise provide information on their identity or, if the information is available online, they may be required to install specific software. Awareness raising campaigns with the support of industry associations (both financial institutions and MSMEs) and the use of diversified media (e.g. TV, radio, press, social media) would be first steps in sharing information about financing solutions for MSMEs and the terms and conditions at which they are available (including interest rates). Regular dialogue and cooperation between the financer and MSME sector could also result in initiatives (e.g. help desks) that can assist MSMEs in making informed choices.

Fair lending practices[505]

251. The paragraphs above note the importance of transparent contract terms and their manner of disclosure to facilitate access to credit. This however may not be sufficient to limit the risk of unsuitable credit arrangements for MSMEs. Fair contract terms and business practices are other key elements of a balanced relationship between financers and MSMEs.[506]

a. Unfair contract terms

252. As "repeat players" and in order to reduce transaction costs, financers tend to use standard term contracts for financial transactions with counterparts (including MSMEs).[507] Negotiation and any resulting variation of the standard term contracts would result in an increase in the transaction costs that financers may not consider economical when the requested loan amount is relatively small (e.g. in the context of MSME financing). Personalization of contracts may also result in higher borrowing costs for MSMEs.[508] Due to their limited bargaining power, MSMEs, in particular MSEs, often enter into contracts for financial transactions on a "take it or leave it" basis.[509]

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[502] A/CN.9/780, para. 37.
[503] Ibid., para. 40.
[504] Ibid.
[505] At its thirty-seventh session, the Working Group agreed to combine section G of A/CN.9/WG.I/WP.126 on Safeguards against unfair practices with the section on Transparency (A/CN.9/1090, para. 89). The secretariat has implemented that change and, in addition, has revised the title of the subsection for improved consistency. The Working Group may wish to note that the secretariat will further research on the topic of unfair lending practices to see whether additional measures to protect MSMEs (in particular MSEs) can be added in the next iteration of the draft Guide.
[506] The secretariat has added this sentence for improved clarity of this subsection.
[507] It is quite common that the procedural terms (e.g. limitations in the methods of drawdown and repayment, the methods whereby the borrower is notified of changes, how and where disputes are resolved) and substantive terms (such as the interest rate after default or the way "default" is defined) in a financing contract are standard terms of the financers.
[508] L. Gullifer, I. Tirado, A global tug of war (supra, footnote 265), pp. 12–13.
[509] Australian Security and Investment Commission (ASIC), Report 565, Unfair contract terms and small business loans, 2018, p. 4, available at: https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-565-unfair-contract-terms-and-small-business-loans/.

253. Given the limited financial literacy of many MSEs, they may not be able to identify or fully understand the potential detrimental contractual conditions.[510] For example, certain clauses may give the financers a broad power to vary the contract without the MSE agreement; other clauses may entitle the financer to call a default based on a breach of some financial indicators such as loan-to-valuation ratio.[511] As a result, MSEs may suffer from certain financers who abuse their stronger bargaining position. The risk of such abuse is particularly high in the context of FinTech products and services,[512] given the speed with which contracts are concluded electronically, often without prior or sufficient review of their terms and conditions.[513] There is also a risk that second-level financial entities may use unclear or deceptive contract terms since they are largely unregulated and can leverage the fact that they can provide loans more promptly than regulated financial providers, which easily attract MSEs. For example, it has been reported that small print clauses in their documentation stipulate higher interest rates than what is advertised in their marketing materials or that they impose "capital repayment fees" that allow the financial entity to claim a percentage of capital at loan settlement.[514]

254. In order to tackle unfair contract practices, some countries[515] have extended to MSEs domestic legislation that protects weaker individuals negotiating contracts with parties who enjoy a stronger bargaining position, including financial transactions.[516] For example, the legislation specifies what a small business is and clarifies the parameters according to which a contract term can be deemed unfair. This may occur when the term: (i) would cause a significant imbalance in the parties' rights and obligations arising under the contract; (ii) is not reasonably necessary to protect the legitimate interests of the party that would benefit from its inclusion; and (iii) would cause financial or other detriment (e.g. delay) to a small business if it were to be applied or relied on.[517] Examples of unfair terms and conditions may include high default interest rates, unfair termination clauses or disadvantageous definitions of events of default.[518] In other countries the goal of ensuring fair contract terms and conditions has been achieved through policy measures enacted by Central Banks,[519] or voluntary codes of conduct or practice standards in the financial industry sector set the benchmark for fair lending practices.[520] Although such tools might be more rigid than certain regulatory or legal standards and afford high levels of protection to small

[510] World Bank Good Practices for Financial Consumer Protection (supra, footnote 468), p. 34. The secretariat has moved reference to "clauses in small print and technical language" to paragraph 247 for consistency (see supra, footnote 498).

[511] The secretariat has added these examples for improved clarity.

[512] A survey carried out by a United States small businesses' association found out that 74 per cent of the respondents felt that online lending should be regulated to ensure that small businesses were protected from predatory online practices. See Small Business Majority, Opinion Poll Small Business Owners Concerned with Predatory Lending, Support More Regulation of Alternative Lenders, 2017, available at: https://smallbusinessmajority.org/our-research/access-capital/small-business-owners-concerned-predatory-lending-support-more-regulation-alternative-lenders.

[513] Ibid.

[514] The secretariat has added examples of unfair practices of second-tier lending as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 90). Second tier financial institutions do not hold a banking license they can include building societies and credit unions and generally use their own wholesale funding from sources other than customer deposits.

[515] E.g. Australia, see supra, footnote 509.

[516] The secretariat has deleted the second sentence ("For example … service sector") of this paragraph (para. 235 of A/CN.9/WG.I/WP.126) to eliminate redundancy.

[517] Australian Security and Investment Commission (supra, footnote 509), p. 8.

[518] A/CN.9/913, para. 42.

[519] E.g. Malaysia. See the policy Fair Treatment of Financial Consumers, 6 November 2019, issued by Bank Negara Malaysia (i.e. the Central Bank), available at https://www.bnm.gov.my/documents/20124/761679/FTFC_PD_028_103.pdf/f83853d4-7146-9842-a40c-7e20bf0c9b75?t=1590696786502. The term "financial consumer" also includes "a micro or small business as defined in the notification on Definition of Small and Medium Enterprises (SMEs) issued by the Bank on 27 December 2017 (BNM/RH/NT 028–51)".

[520] E.G. United Kingdom. The Standards of Lending Practice for business customers (2020) which were formally recognized by the Financial Conduct Authority (FCA) in 2020.

businesses, they cannot be an alternative to an appropriate legal regime with enforceable norms that sets out the obligations of the financers.[521]

255. In countries that wish to reform their legal framework in line with international best practices, the law would, for instance, prohibit unfair terms or conditions in standard financial contracts and, if used, such terms or conditions would be considered void and legally unenforceable.[522] Another good practice often used by the law is to construe any ambiguity in a standard contract against the interests of the party that proposed the ambiguous term, thus leading to an interpretation more favourable to the weaker party of the contract, i.e. the MSE.[523] In this regard, it has been noted that the fairness of a contract term, in particular 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.[524] 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.

256. Supervisory authorities can play a key role in ensuring fairness of contract terms and it would be important for the domestic legal framework to clearly establish their responsibility, especially their authority to assess compliance of the lending agreements with the established legal requirements. This would include the ability to clarify the meaning and scope of unfair contract terms in a transparent manner (e.g. in certain countries the threshold for unfairness of terms may be higher for commercial lending contracts than for individual consumers) so to ensure commercial certainty. In some countries, for example, supervisory authorities analyse MSME lending agreements on a regular basis in order to identify abusive terms and clauses and take appropriate actions. In others, they also maintain registries that display abusive contract clauses which allows MSMEs to ascertain whether their agreement with the financer includes abusive or unfair terms.[525,526]

b. Contract formation[527]

257. Fair treatment of MSEs would also require that in the process of contract formation the financer explains the different types of credit suitable to the MSE and their implications for the business,[528] and clarifies the meaning of the respective contractual terms, in particular the financial terms such as those concerning interest rates, in a way that they are understandable and comparable to the terms used by other financers. In addition, the domestic legal or regulatory framework may require that financers 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. 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.[529] In case the MSE's credit

[521] The secretariat has added reference to other measures against unfair contract practices for improved clarity.
[522] World Bank, Good Practices (supra, footnote 468), p. 34.
[523] Ibid., p. 34.
[524] L. Gullifer, I. Tirado, A global tug of war (supra, footnote 265), p. 14.
[525] World Bank, Good Practices, p. 35 (supra, footnote 468).
[526] The secretariat has added reference to the role of supervisory authorities in ensuring the fairness of contract terms and its relevance for commercial certainty as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 90).
[527] The secretariat has separated the discussion on contract formation from that on unfair contract terms for improved clarity and in line with the deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 89).
[528] For example, Belgium. See Loi relative à diverses dispositions concernant le financement des petites et moyennes entreprises, 21 Decembre 2013, available at: www.ejustice.just.fgov.be/cgi_loi/change_lg_2.pl?language=fr&nm=2013003461&la=F.
[529] For example, Germany and Spain, L. Gullifer, I. Tirado, A global tug of war (supra, footnote 265), pp. 14–15.

application is rejected, applicable laws or regulations may require financers to provide the reasons for rejection in a clear and understandable way.[530]

c. Unfair business practices

258. In addition to fair contract terms, an appropriate legal and regulatory framework would also provide consequences for relationships between the financers and the MSEs that are unfair, abusive and discriminatory. Unfair practices, such as unsolicited SMS loan offers, sending credit cards without a customer's prior request, discriminating on the basis of sex, may be in place even when contract terms and conditions are fair and balanced. In certain States, for example, regulated financial entities must demonstrate how the concept of fair treatment is embedded in all their customer-related practices.[531] Another good practice is for States to set a minimum threshold to identify whether a practice is unfair or not.[532] With regard to credit products, financers may be required to use the so-called reducing interest rates (i.e. calculated on the outstanding loan amount) instead of flat interest rates (i.e. calculated on the full loan amount). As flat interest rates do not take into account the fact that each repayment instalment gradually reduces the full loan amount, customers may end up paying more interests compared with reducing interest rates. In addition, financers may also be required to adopt opt-in clauses for facilities that auto-deduct payments and fees, and refrain from using abusive loan collection practices.[533]

259. Defining unfair practice standards might be influenced by domestic social and cultural norms, for example in certain countries requiring women entrepreneurs to have spousal consent to obtain a loan might be considered an acceptable practice.[534] Be that as it may, in several countries the law addresses the needs and difficulties of particularly vulnerable groups such as women, youth, indigenous people and rural communities and provide appropriate safeguards for these groups. It should be noted that discrimination and unfair practices may easily be embedded in the algorithm supporting digital credit scoring models too, which may result in bias against certain groups of customers. States should thus ensure that their laws or regulations on fair practices are also applicable to providers of digital financial services.

260. Finally, as it has been noted, when adopting rules on unfair contractual terms and practices, it is important that lawmakers attempt to achieve a balance between the measures protecting MSEs and those that motivate financers to lend (see also para. 19). Safeguards designed to facilitate access to credit for MSEs might exceed their goal of ensuring protection against abusive practices as the businesses might use them to avoid repayment, or prolong or avoid disputes, which can disincentivize financers from lending. The appropriate balance will clearly be a matter of policy and will depend on the country's policy as well as social and economic conditions.[535]

Note to the Working Group: *At its thirty-seventh session the Working Group agreed to retain the discussion on Transparency and its various dimensions into one section and to combine it with the paragraphs on "Fair lending practices" (section on "Safeguards against unfair practices" in document A/CN.9/WG.I/WP.126). The Working Group may wish to consider whether certain parts of the discussion (e.g. unfair contract terms) could be better placed in the section on "A Legislative framework supportive of debt tools to enhance MSME access to credit".*

[530] For example, Belgium. See supra, footnote 528.
[531] For example the United Kingdom and Malaysia as cited in World Bank, Good Practices (supra, footnote 468) p. 35.
[532] Ibid., p. 36.
[533] Ibid.
[534] Ibid.
[535] L. Gullifer, I. Tirado, A global tug of war (supra, footnote 265), p. 1.

6. Measures to tackle low financial literacy of MSEs[536]

261. Once access to credit for MSE reform has been initiated, an important aspect of the process is improving financial literacy of MSEs 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 MSEs to fully understand the advantages and the consequences of granting a security right over their assets and the legal requirements of a security agreement (e.g. how to create a security right, rights and obligations of the grantor, enforcement).[537] MSEs may also need a wider set of skills to operate proficiently within their business environment and to improve their transparency on the finance market. 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 programmes to the adoption of quality certification schemes) 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.[538] Financial education initiatives may thus be complemented by programmes[539] aiming at strengthening the managerial and technical skills of MSEs. Finally, in countries with external redress mechanisms for financial disputes (see paras. 231 to 242), MSEs are often unaware that they can resolve their disputes with financers through those channels. MSEs 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.[540]

262. Another important aspect of the process is developing the capacity of financers so that they become attuned to the financial needs of MSEs 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 MSEs face in approaching financers, preparing necessary documentation, and meeting relevant criteria. In this respect, building the capacity of financers to efficiently engage in secured transactions (e.g. which assets can be encumbered, asset valuation, enforcement)[541]is as important as for MSEs (see para. 261). Financers also need to know how to enter into transactions made profitable by legal reforms (such as secured transaction law reform). This may apply particularly to financers catering to women entrepreneurs, many of whom have limited access to information and financial literacy at the outset of entrepreneurial activity. Finally, proper understanding of new laws and regulations applicable to MSEs' financing is important for staff of regulatory authorities in order to assist financial institutions in their implementation and ensure adequate supervision. Capacity-building initiatives to help regulators keep abreast of reforms concerning access to credit are thus another key aspect of the process.

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[536] As noted in this section, MSEs are often the most targeted segment of domestic and international financial literacy efforts within the MSMEs' group. For this reason, the section mainly refers to them (and mainly uses the acronym MSEs).

[537] The secretariat has added this phrase ("and the legal … enforcement") for improved consistency of the text. See also a similar reference to capacity-building on secured transactions in paragraph 262 (para. 242 of A/CN.9/WG.I/WP.126). See infra, footnote 541.

[538] OECD and G20, Effective Approaches for Implementing the G20/OECD High-Level Principles on SME Financing, 2018, pp. 30–31.

[539] For example, Italy provides financial support to those MSMEs that are using consulting services to improve production processes and management and organizational structures.

[540] At its thirty-seventh session, the Working Group agreed to highlight the importance of educating small businesses on the use of external redress mechanisms to solve their disputes against financers (A/CN.9/1090, para. 85). The secretariat has implemented that amendment in this section of the draft Guide.

[541] The secretariat has added this sentence in line with deliberations of the Working Group at its thirty-seventh session (A/CN.9/1090, para. 54).

(a) Capacity-building for MSEs

263. 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 (i.e. micro, small or medium-sized) 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, MSEs are often the most targeted segment within the MSMEs' group. Certain countries pursue MSEs' financial education as part of broader strategies aiming at promoting financial inclusion[542] or increasing formal sector employment.[543]

264. Effective strategies at country level may be provided through different channels such as formal education in schools or universities or ad hoc government programmes.[544] The strategies usually cover general elements of financial literacy as well as topics relevant to building the MSE capacity to interact with financers, 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 managing them effectively; and knowing how to meet loan requirements. The long-term sustainability of the strategies not only requires the allocation of sufficient funds, but it is equally important that diagnostic tools to assess MSE's literacy needs and adequate monitoring and evaluation of strategy implementation are in place and that the strategies are independent from a country's political cycles.

265. In addition to government strategies, other initiatives coordinated by industry organizations and trade unions, the financial sector or NGOs may be implemented at the local and country level.[545] For example, the stock exchange industry 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.[546]

266. 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.[547] Other countries, recognizing the great challenges faced by women-run MSEs, 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 MSEs paid-for initiatives be limited. It should be noted that both the government-led strategies and the initiatives coordinated by the private sector often

[542] OECD (authored by A. Atkinson), Financial Education for MSMEs and Potential Entrepreneurs, 2017, p. 31.
[543] Ibid., p. 33.
[544] For example, Argentina has established 51 university MSME centres in 19 Provinces to strengthen MSMEs' capacity to access credit. The country has also established 65 development agencies and entrepreneurship centres in 22 jurisdictions with the same goal.
[545] OECD (authored by A. Atkinson), Financial education (supra, footnote 542), pp. 34–35.
[546] See the ELITE programme launched by the London Stock Exchange Group. See www.aimlisting.co.uk/lse-elite-programme/.
[547] See Chile and Singapore, respectively as cited in OECD (authored by A. Atkinson), Financial education (supra, footnote 542), pp. 52 and 58.

benefit from tools and programmes[548] developed by international organizations or networks[549] that reflect global best practices.

(b) Capacity-building for financers

267. As noted above (see para. 262), it is important to improve the capacity of financers to respond to MSE's financial needs and understand how to enter into profitable transactions with them. For example, certain countries have adopted policies to address the information gap between financers and small businesses by facilitating their direct interaction through awareness-raising campaigns, brokerage and match-making.[550,551] More generally, financers should be equipped with tools to understand the sectors in which MSEs 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 MSEs, or particular groups of MSEs; develop an appropriate sales culture and distribution channels as well as appropriate risk management strategies to sustain solid MSEs in critical moments of their life cycle.[552]

268. As noted earlier, it is important that financers receive guidance (e.g. code of conducts, coaching, training) on best lending practices applicable to their transaction with MSEs so they can limit their risks without reducing protection for the MSE. For example, financers should be able to effectively advise MSEs 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 MSEs experience payment difficulties. 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 delay MSEs' access to credit (as they result in longer credit processing time), they ensure that financers act in the best interest of the business throughout the lending process. Countries may thus consider raising financers' awareness on the relevance of responsible lending practices for MSEs too.[553]

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[548] These tools and programmes either focus on MSEs' financial literacy needs or have a broader goal (e.g. support entrepreneurship) with financial literacy being one of the components of the programmes.

[549] For instance, the OECD/International Network on Financial Education (OECD/INFE), with members from 130 countries, has taken stock of best practices around the world and has produced a framework for policymakers and other entities engaged in promoting entrepreneurships (e.g. NGOs, chambers of commerce) in order to assist them in developing or improving strategies for MSE financial education and for assessing their financial literacy. See OECD/INFE, Core Competencies Framework on Financial Literacy for MSMEs, 2018. Further, an international forum specializing in MSMEs access to finance has developed a platform to promote knowledge exchange, research and best practice sharing in SME finance. See SME Finance Forum at www.smefinanceforum.org/about/what-we-do.

[550] See OECD, Discussion Paper, SME Ministerial Conference, 22–23 February 2018 (supra, footnote 8), p. 19.

[551] The Working Group may wish to note the secretariat has not been able to find more specific examples of channels facilitating exchange of information on access to credit between financers and MSEs (A/CN.9/1084, para. 65).

[552] IFC/World Bank, Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises, p. 17.

[553] At its thirty-seventh session the Working Group agreed to add a discussion, in the section of the draft Guide concerning capacity-building, on: (i) best lending practices, including responsible lending practices (A/CN.9/1090, para. 47); and (ii) building the financers' capacity to monitor loans and advise MSMEs (A/CN.9/1090, para. 92). The secretariat has added this paragraph to implement that decision.

269. Capacity-building initiatives for financers may be organized under the aegis of central regulators[554] or the relevant government authorities[555] and include training programmes for those in charge of MSEs' departments, including training of trainers; peer-to-peer learning or advisory services. Moreover, financial service providers should develop their in-house programmes, such as workshops or on-the-job training, to ensure regular improvement of staff expertise and skills in dealing with MSEs.[556]

270. As in the case of financial literacy for MSEs, international organizations[557] are also active in offering support to improve financers' capacity to serve MSEs through technical assistance activities[558] 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 MSE 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 MSEs, how secured transactions can facilitate access to credit at a reasonable cost.

(c) Capacity-building for regulators

271. Regulatory and supervisory bodies play a leading role in facilitating access to credit for MSEs. They must be able to create and maintain a conducive environment for MSE lending, foster competition among financial institutions to serve MSEs and oversee the application of regimes on credit information and payment systems, or transparency in lending.[559] 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.

272. In order to adequately respond to the multiple demands of the financial sector, regulators must thus have a diverse set of skills and update them over time. States can support regulators through mechanisms that 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. As noted earlier (see para. 82), regulatory sandboxes also provide a valuable protected environment for regulators where they can learn from new products and credit providers, in particular FinTechs related, and enhance their capacity to adjust

[554] For example, the Reserve Bank of India has launched a National Mission for Capacity Building of Bankers for Financing the MSME sector which involves training initiatives, including training of trainers, for those in charge of MSME divisions and specialized branches for MSMEs in commercial banks. See www.bis.org/review/r170629g.htm.

[555] For example, in Zambia the National Financial Inclusion Strategy 2017–2022 among others aims to build the capacity of financers to lend to MSMEs, in particular farmers. See www.boz.zm/National-Financial-Inclusion-Strategy-2017-2022.pdf.

[556] See the Alliance for Financial Inclusion, Financial Education for the MSMEs: Identifying MSME Educational Needs, 2020, p. 7.

[557] See for example, the capacity-building initiatives of the World Bank, the International Finance Corporation and the European Bank for Reconstruction and Development, cited in paras. 200 and 201 of A/CN.9/WG.I/WP.124.

[558] For example, the World Bank, among others, has supported the Lao People's Democratic Republic, in establishing a programme that supports small and medium-sized enterprises' access to finance and strengthens the capacity of banks and other financial institutions to serve those businesses.

[559] The secretariat has deleted reference to building the capacity of the regulators in relation to informal funding mechanisms (last two sentences of para. 249. of A/CN.9/WG.I/WP.126) as requested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 93).

the existing regulatory framework to the evolving needs of the financial sector.[560] Workshops and seminars, whether online or in presence, permit to improve regulators' knowledge with the assistance of experts and to delve into specific topics in greater depth. Again, international organizations and networks[561] 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[562] and partner with States and regional entities to offer technical assistance and advisory programmes tailored to the needs of a specific country or region.

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[560] The secretariat has added reference to the learning function of regulatory sandboxes as suggested by the Working Group at its thirty-seventh session (A/CN.9/1090, para. 93).

[561] Regional cooperation has also recently emerged for regulatory capacity-building on MSE access to credit. For example, an international capacity-building event conducted by Costa Rica's Superintendencia General de Entidades Financieras (SUGEF) and the Alliance for Financial Inclusion (AFI) in late 2020 involved 89 senior officials from 44 AFI member institutions and was based around several knowledge products on SME finance, including a guideline note and a factsheet on COVID-19 in AFI member countries. The Asia-Pacific Economic Cooperation (APEC) has instituted an Advisory Group on Financial System Capacity Building which since 2011 publishes annual reports on policy reforms by member economies, including regulatory developments to improve MSMEs' access to finance (cf. APEC, 2021 Progress Report of APFF, APFIF and APIP, *passim*).The European Union has been cooperating with the Organisation of African, Caribbean, and Pacific States in a string of projects including the ACP-EU Microfinance Program, the EU Support to Policy Dialogue on Investment Climate or the European Investment Bank's SME Access to Finance Initiative.

[562] See for instance, Bank for International Settlement, The policy life cycle and capacity-building needs of financial sector authorities, keynote address, by Agustín Carstens, 2018, available at: www.bis.org/speeches/sp180208.htm.