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

Note by the Secretariat

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Background information

1. At its fifty-second session, in 2019, the Commission agreed to strengthen and complete 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. 5).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 (hereafter the "draft Future Text") contained in a Note by the Secretariat (A/CN.9/WG.I/WP.124). At that session, 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 The Annex to this document contains a revised version of the draft Future Text which reflects the deliberations of the Working Group.³ Moreover, the secretariat has made additional adjustments to improve the cohesion and consistency of the text. Where necessary, the paragraphs have been moved and renumbered and any cross references modified accordingly.

1. Purpose

3. The aim of the Future Text is to provide guidance on the adoption or reform of domestic legal frameworks to facilitate access to credit in particular of micro and small enterprises (MSEs) also in light of the difficulties that many of them around the world are currently facing and may continue to face in the future as a result of financial, environmental and other crisis, such as climate change or the coronavirus disease (COVID-19) pandemic that occur locally or globally.⁴ For this reason, the Future Text 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 operational interventions to the extent they can ensure effectiveness of the legislative measures in reducing MSEs' constraints to access credit. While its main focus is on MSEs, the Future Text will not completely exclude medium-sized ones and clarify, as appropriate, the different provisions and policy measures applicable to them.⁵

Note to the Working Group: In keeping with its decision that the Future Text should be based on the principle "think small first", the Working Group may wish to advise the secretariat whether all references to "MSMEs" in the Future Text should be replaced by "MSEs".

2. Intended audience

4. The Future Text will be addressed both to States lacking a specific legal framework supporting MSE's access to credit as well as to States aspiring to modernize their existing laws with a view to facilitating access to credit for MSEs 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

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.

³ See A/CN.9/1084.

⁴ The secretariat has revised this sentence in keeping with deliberations of the Working Group at its thirty-sixth session that the Future Text should not limit its reference to the Covid-19 but rather look at emergency situations in general (A/CN.9/1084, para. 13).

⁵ The secretariat has added reference to the focus of the Future Text consistent with the deliberations of the Working Group at its thirty-sixth session (A/CN.9/1084, para. 26).

that are interested or actively involved in improving the legal framework of access to credit for MSEs may also benefit from the Future Text.

5. 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 Future Text.

3. Working method

6. 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 Future Text 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.

7. Similarly, the parts of the Future Text 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.⁶ Worldwide, they make up more than 90 per cent of businesses (in some countries they constitute about 90 per cent of the domestic productive sector)⁷ and 60–70 per cent of total employment when both formal and informal MSMEs are considered.⁸ 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.⁹ As it has been noted,¹⁰ 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.¹¹ 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.¹² 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.¹³

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.¹⁴ A number of factors affects access to credit and the type of the credit that can be obtained including age of the enterprise, gender of the entrepreneur, operation of personal and business bank accounts by the entrepreneur, 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, in several countries small businesses do not often use formal credit as they do not meet the requirements set by those financial institutions. In particular, it is difficult for many MSMEs to provide valuable collateral or the type of reliable information with respect to their creditworthiness usually required by the financial institutions (e.g. lack or insufficient financial reporting).¹⁵ These obstacles are exacerbated for all those MSMEs operating in the informal sector. National laws may use criteria such as the

⁶ WTO, World Trade Report 2016, (2016), p. 18.

⁷ See for instance Colombia, UNCITRAL fifty-fourth Commission session, TAC panel on 16 July 2021.

⁸ ITC, SME Competitiveness Outlook 2015: Connect, Compete and Change for Inclusive Growth, (2015), p. 1.

⁹ Ibid., p. 13.

¹⁰ UNDESA, Report on Micro, Small and Medium-Sized Enterprises (MSMEs), and their role in achieving the Sustainable Development Goals, 2020, pp. 4 and 22.

¹¹ See www.worldbank.org/en/topic/smefinance.

¹² See www.centerforfinancialinclusion.org/microfinance-vs-financial-inclusion-whats-the-difference.

¹³ OECD, Discussion Paper, SME Ministerial Conference, 22–23 February 2018, Mexico City, Enhancing SME access to diversified financing instruments, p. 6.

¹⁴ See www.worldbank.org/en/topic/smefinance.

¹⁵ 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.

size of the business, 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 Future Text considers an MSMEs that has not complied with all mandatory registration and other requirements of the States in which it is established as operating in the informal economy.¹⁶ 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 permit MSMEs to access credit more easily.

5. Even when MSMEs meet the required qualifications of the formal financing sector, financial institutions might still be reluctant to issue loans to micro and small enterprises (MSEs) in particular because those loans are often too small to be profitable.¹⁷ 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”.¹⁸ A 2017 working paper by the International Finance Corporation (IFC) estimating the unmet demand for financing from formal MSMEs in developing countries reveals a gap of USD 5.2 trillion.¹⁹ According to the study, there are 65 million credit-constrained formal MSMEs, representing 40 per cent of all enterprises in the 128 reviewed countries, 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.²⁰

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. For instance, in some countries women are reported to have less access to affordable credit since they have less physical and reputational collateral,²¹ particularly as their microfinance repayment rates are often not captured by private credit reporting service providers.^{22,23}

7. Constrained access to formal credit thus results in many MSMEs relying on credit obtained through informal arrangements (see chapter III, section A and chapter IV, section A on family and friends support below) 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 global and national level. It would also make an impact on achieving the sustainable development goals (SDGs).²⁴ The International Trade Centre (ITC) suggests that stronger MSMEs can contribute to achieving SDGs 8 and 9 through the business practices they adopt, the

¹⁶ At its thirty-sixth session, the Working Group agreed to clarify the meaning of “formal” and “informal” sector (A/CN.9/1084, para. 20). The secretariat has implemented that revision in this paragraph (para. 5 of A/CN.9/WG.I/WP.124) instead of including it in the discussion of how access to credit may be affected by the legal form of the business (para. 18 of the Future Text).

¹⁷ Z. Chen and M. Jin, *Financial Inclusion in China: Use of Credit*, 2017, p.3.

¹⁸ IFC, *MSME Finance Gap, Assessment of the shortfalls and opportunities in financing micro, small and medium enterprises in emerging markets*, 2017, p. 2.

¹⁹ This figure is the difference between the potential demand of USD 8.9 trillion minus the credit supply of USD 3.7 trillion. See International Finance Corporation (IFC), *MSME Finance Gap* (supra, footnote 15), pp. 27 et seq.

²⁰ 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.

²¹ 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.

²² ITC, *Unlocking Markets for Women to Trade*, 2015, pp. 23 and 25.

²³ The secretariat has replaced the term “credit bureau(x)” with a term expressly indicating the private nature of a credit bureau(x) here and throughout the Future Text as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 45). See *infra*, footnote 381.

²⁴ Inter-agency Task Force on Financing for Development, *Financing for Sustainable Development Report 2020*, 2020, p. 8, box I.2.

sectors in which they operate and their impact on the broader economy.²⁵ It further emphasizes that MSMEs can have a positive impact on 60 per cent of the individual SDG targets with sufficient funding in place.²⁶ Improved access 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*²⁷

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,²⁸ or direct lending programmes to MSMEs²⁹ or facilitating the adoption of measures to improve competition within the domestic financial systems and allow a variety of financial institutions to operate.³⁰ Others have favoured the adoption of soft support policies and regulations including implementation of capacity-building programmes for MSMEs, financiers and regulators and strengthening of credit reporting systems.³¹ Recognizing that women-owned MSMEs often face higher barrier 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.³²

²⁵ 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.

²⁶ *Ibid.*, p. xv.

²⁷ At its thirty-sixth session, the Working Group requested the secretariat to make the section "An overview of initiatives to improve access to credit for MSMEs" (paras. 49 to 64 of [A/CN.9/WG.I/WP.124](#)) a separate stand-alone section ([A/CN.9/1084](#), para. 27). Since the secretariat has largely reorganized the structure of the Future Text, that section has been considerably revised, also to eliminate all time-bound references, and included in the Introduction under a different sub-heading ("Reform trends").

²⁸ 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 20), 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).

²⁹ 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).

³⁰ 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 15).

³¹ 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).

³² 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

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),³³ 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.³⁴ In this regard, it is worth noting that the United Nations through the Task Force on Digital Financing for the Sustainable Development Goals has recommended, among others, legal reforms to support the digitalization of the financial system, for example defining the legal nature of digital assets or improving private law regimes governing relations between commercial parties.³⁵

10. Finally, several initiatives, in particular at 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.³⁶ Other reforms have pursued formalization of small businesses, through simplified incorporation and streamlining business registration (see Chapter IV, Section E and Chapter VI, Section A), 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 States with different needs and economic conditions. Those best practices address different factors that negatively affect the decision of financiers 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 in addition to designing a framework that balances financiers 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.

creation of an enabling policy and regulatory financial environment for women entrepreneurs. See www.unescap.org/projects/cwe.

³³ The Group of 20, usually known as the G20, is an intern-governmental 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.

³⁴ World Bank, Promoting digital and innovative SME financing, 2020, p. 9. Available at: www.gpfi.org/sites/gpfi/files/saudi_digitalSME.pdf.

³⁵ In 2018, the UN 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.

³⁶ 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).

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. 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 III, Section H.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 financiers 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 not undermine the legislative instruments that facilitate access to credit and vice versa.³⁷

14. In keeping with the mandate of UNCITRAL, the Future Text will mainly focus on the domestic legal frameworks on access to credit and their 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 Text will also discuss relevant policy and operational interventions to the extent they can ensure effectiveness of the legislative measures in reducing MSMEs' constraints to access credit.

II. MSMEs and their financing needs at various stages³⁸

15. 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.³⁹ 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.

16. Despite their varying nature and size, most MSME broadly share some common characteristics. They include the following:⁴⁰ (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 micro and small businesses, 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.

³⁷ 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).

³⁸ The secretariat has revised Chapter two of the Future Text by combining sections A (MSMEs and the importance of access to credit, paras. 1 to 9) and B (Challenges faced by MSMEs to access credit, paras. 10–46) of A/CN.9/WG.I/WP.124 into one discussion. The discussion on the finance gaps (paras. 5–7 of A/CN.9/WG.I/WP.124) and on the relevance of access to credit for achieving the SDGs (para. 9 of A/CN.9/WG.I/WP.124) has been moved to the Introduction of the current revision. Further, the secretariat has expanded the second part of Chapter II to briefly discuss issues concerning Islamic finance as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 62).

³⁹ IFC, *MSME Country Indicators 2014: Towards a Better Understanding of Micro, Small, and Medium Enterprises*, (2014), p. 5 et seq.

⁴⁰ A/CN.9/941, para. 12.

17. As regards MSMEs' access to credit specifically, two observations can be drawn from these characteristics. First, for many MSMEs, there may be no separation of assets between the entrepreneur and the business, particularly in the case of sole proprietorship or when the business does not have a distinct legal personality.⁴¹ Second, the limited access to formal financial services often results in strong reliance on informal financial arrangements in particular by MSEs.⁴² 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's 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.⁴³ From the financiers' point of view, limited access to information on MSMEs, in particular MSEs, 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.⁴⁴

18. Reforms aimed at improving MSME access to credit should consider those aspects and strike a balance between the lending risk of financiers and the need to protect MSMEs, in particular the simplest ones, against onerous loans, heavy interest fees or other onerous conditions to access credit. States may thus wish to adopt measures aimed at addressing MSME financing constraints specifically and economic conditions in general so that credit remains at affordable rates without giving up any necessary protection or jeopardizing sound banking operations. These actions would provide an incentive to the financial institutions to lend to this segment of the economy. To maximize their impact, it would also be important that States tailor the measures based on the legal form of MSMEs, for example whether natural or legal persons, since small businesses may face different financing constraints depending on their legal form. States should also clarify the scope of these measures: while some measures may apply to all MSMEs (for example, secured lending), others may have limitations on eligibility (for example, credit guarantee schemes).⁴⁵

19. 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,⁴⁶ 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,⁴⁷ and accumulating savings and credit associations⁴⁸). MSMEs (often MSEs) at initial stages with growth

⁴¹ For improved coherence of the text, the secretariat has revised this sentence to clarify that not all legal forms of MSMEs benefit from asset partitioning.

⁴² 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.

⁴³ The secretariat has highlighted, here and elsewhere in the Future Text, the challenges faced by women entrepreneur in keeping with deliberations of the Working Group at its thirty-sixth session (A/CN.9/1084, para. 41).

⁴⁴ World Bank, International Committee on Credit Reporting (ICCR): Facilitating SME financing through improved credit reporting, 2014, p. 1.

⁴⁵ In keeping with the deliberations of the Working Group at its thirty-sixth session, the Secretariat has added two final sentences to this paragraph (para.8 of A/CN.9/WG.I/WP.124) to clarify that (i) measures to facilitate access to credit for MSMEs need to take into account their different legal form; and (ii) not all financing tools may be applicable to all MSMEs (A/CN.9/1084, para. 19).

⁴⁶ The secretariat has replaced the term "start-up" with "initial stages" throughout the document as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 24).

⁴⁷ 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.

⁴⁸ 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.

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 MSMEs (often MSEs) at initial stages.

20. As MSMEs grow and build a reliable credit record, other sources of financing such as bank credit, trade finance and venture capital (VC) may become increasingly available. Bank 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. Trade finance is the term used to describe the arrangements available to buyers (importers) and sellers (exporters) that are used to mitigate risks and ensure that the terms and conditions of an underlying commercial contract are met, so that the exporter receives payment and the importer receives the goods or services. 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).

21. Finally, mature medium-sized enterprises may access capital markets and issue debt and equity through stock exchange markets or private placements.⁴⁹ Capital markets are a key source of equity and debt finance but remain underdeveloped in many countries and are mostly inaccessible to small businesses at a relatively early stage of development. Public listing on stock exchanges and corporate bonds are two types of capital market instruments potentially accessible to mature medium-sized enterprises, but not micro- and small businesses.

22. For the avoidance of doubt, such classification broadly reflects MSMEs' current preferences concerning access to credit but does not intend to suggest that certain type of financing sources is used by MSMEs only during a certain stage of development. While most of these sources of financing may be subject to existing general legal, policy and regulatory frameworks, certain mechanisms such as those involving microcredit and crowdfunding are often more adapted to the needs of MSEs.

23. Notably, some 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).⁵⁰ Islamic financial products in the market can be divided into two broad categories: asset-based and equity-based financial products.⁵¹ *Murabaha* is the most commonly used asset-based financing method for MSMEs, under which the financier purchases assets required by the client and then sells them to the client at a cost that includes a disclosed profit margin to be paid back, usually in instalments.⁵² As regards equity-based Islamic financial products, *Musharaka* is a 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.⁵³ *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. 121 below).⁵⁴ Considering that some MSMEs, especially family businesses, may be reluctant to give up ownership

⁴⁹ IMF, *Financial Inclusion of Small and Medium-Sized Enterprises in the Middle East and Central Asia*, (2019), p. 21.

⁵⁰ UNCITRAL Legislative Guide on Public-Private Partnerships (2021), Chapter A "Introduction", para. 65.

⁵¹ World Bank – Islamic Development Bank Policy Report: *Leveraging Islamic Finance for Small and Medium Enterprises* (2015), p. 11.

⁵² *Ibid.*, pp. 11 and 13.

⁵³ *Ibid.*, p. 16.

⁵⁴ *Ibid.*

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.⁵⁵ In recent years, Islamic financial products have also been developed in some jurisdictions in the context of crowdfunding and factoring.⁵⁶

24. 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.⁵⁷ 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.⁵⁸

III. Debt tools for MSMEs to access credit

25. This chapter lists various debt tools available on the market for MSMEs to access credit (e.g. family and friends support, credit cards, microcredit, credit cooperatives, bank credit, trade finance and corporate bonds), identifies existing frameworks relevant to commercial law and analyses the challenges faced by MSMEs and financiers when using these tools.

A. Family and friends support

26. Microenterprises often rely on family and friends for initial capital.⁵⁹ Based on a survey of the Consultative Group to Assist the Poor (CGAP), it is common for small businesses to borrow money from family and friends.⁶⁰ In a survey of women-run businesses in the Middle East and North Africa, the World Bank revealed that most women-owned enterprises do not have access to formal credit, and financed their business mainly through loans from family and friends as well as personal savings.⁶¹

27. Family and friends support can come in the form of debt, equity or guarantee. For debt, the terms of the loan are often agreed orally and not written down. Oral agreements often lack clarity on the terms and conditions of the loan, repayment schedules and remedies for defaults. Such informal debt arrangements are often subject to the existing frameworks relevant to commercial law concerning contract formation and dispute resolution, to the extent that the existence of some kind of oral or written agreement can be proved. Support from family and friends is rarely a

⁵⁵ *Ibid.*, p. 17.

⁵⁶ EBRD, *Smart Contracts, Blockchain and Crowdfunding: How the Law is Getting to Grips with Technology*, p. 30.

⁵⁷ 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.

⁵⁸ *Ibid.*, p. 18.

⁵⁹ Inter-agency Task Force on Financing for Development (*supra*, footnote 24), p. 67; UNESCAP, *Small and Medium Enterprises Financing*, (2017), p. 3.

⁶⁰ CGAP, *Executive Summary – CGAP National Surveys of Smallholder Households*, (2018), p. 15.

⁶¹ World Bank, *Secured Transactions, Collateral Registries and Movable Asset-Based Financing*, (2019), p. 23.

guaranteed source of financing for all types of businesses. In this regard, the MSME financing sector does not face challenges substantially different from those faced by large firms, except that MSMEs are more vulnerable economically, more dependent on such financing and may be less aware of their rights and obligations in relation thereto.

B. Credit cards

28. 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 banks 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.

29. The issuance of credit cards is usually subject to existing laws and regulations governing commercial contracts and dispute resolution, as well as existing regulatory frameworks concerning the operation of banks (including specific regulatory frameworks 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.

C. Microcredit⁶²

30. Microcredit 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. Microcredit is also known as "microloan". 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.

31. 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.⁶³ Loans are often the first

⁶² The Secretariat has elaborated on microcredit as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 62).

⁶³ European Investment Fund, European Small Business Finance Outlook, 2019, p. vi.

product that MFIs offer to clients.⁶⁴ Microfinance has made a major contribution to improve microenterprises' access to credit,⁶⁵ particularly for businesses run by women. Eight out of every ten microfinance clients in the world are likely to be women entrepreneurs.⁶⁶

32. The extension of microcredit is usually subject to existing laws and regulations governing commercial contracts and dispute resolution, as well as certain specific legal or regulatory frameworks 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.⁶⁷

33. 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.⁶⁸ The *CGAP National Surveys of Smallholder Households* (2018) reveals, for example, that mobile money is the most important formal financial tool, yet few smallholder households in the surveyed countries own smartphones.⁶⁹

D. Credit co-operatives

34. According to the Statement on Co-operative Identity adopted by the International Co-operative Alliance⁷⁰, “[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.

35. 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

⁶⁴ 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.

⁶⁵ 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.

⁶⁶ World Bank, *Secured Transactions* (supra, footnote 61), p. 23.

⁶⁷ [A/CN.9/727](#), paras. 29 to 52; [A/CN.9/780](#), para. 37.

⁶⁸ European Investment Fund (supra, footnote 63), p. vi.

⁶⁹ 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 60).

⁷⁰ See International Co-operative Alliance [webpage](#) on “Cooperative identity, values & principles”.

feature of being member owned. While some credit co-operatives are informal and 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.⁷¹ 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.⁷² Cooperative banks are owned by the customers and often offer more favourable interest rates compared with other commercial banks.⁷³

36. 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.⁷⁴ 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.

37. 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.⁷⁵ 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.⁷⁶

⁷¹ 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.

⁷² See European Association of Co-operative Banks [webpage](#) on “Characteristics of the co-operative banking model”; 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. 10.

⁷³ European Central Bank Working Paper Series No. 1568, Bank Lending and Monetary Transmission in the Euro Area (July 2013), p. 7, footnote 4.

⁷⁴ See generally International Labour Office Working Paper INT/92/M01/FRG, Tontines and the Banking System – Is There a Case for Building Linkages?

⁷⁵ IFC, Research and Literature Review of Challenges to Women Accessing Digital Financial Services (2016), p. 10.

⁷⁶ European Central Bank (supra, footnote 73), p. 7, footnote 4.

E. Bank credit

38. Bank 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 (also known as “traditional lending”). According to OECD, the demand from small and medium-sized enterprises for bank credit in the form of traditional lending varied significantly from one country to another in 2018, even in the same geographical region.⁷⁷ The share of outstanding small and medium-sized enterprises’ loans to total business loans also varied materially across countries.⁷⁸

39. Existing laws and regulations governing commercial contracts and dispute resolution, as well as existing regulatory frameworks concerning the operation of banks need to be taken into account when extending bank credit. Specific challenges that limit this form of bank credit to MSMEs in some countries largely relate to the difficulties that financiers encounter in assessing and monitoring the creditworthiness of MSMEs. Firstly, information asymmetry due to MSMEs’ lack of supporting financial information infrastructure limits financiers’ ability to lend.⁷⁹ MSMEs often lack the expertise and skills needed to produce adequate financial statements. As a result, financiers 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.⁸⁰ Financiers 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.

40. In order to mitigate credit risk, financiers often impose strict collateral and guarantee requirements on MSMEs. 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.⁸¹ 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, financiers 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.⁸² 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 MSMEs⁸³ (see Chapter VI, Section B on credit guarantee schemes below).

41. Last but not least, a lack of competition among financiers reduces access to credit for MSMEs.⁸⁴ 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.⁸⁵ 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

⁷⁷ 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 20), p. 33.

⁷⁸ In 2018, the share of outstanding SME loans to total business loans varied significantly across countries, ranging from around 20 per cent or less in Canada, Chile, France, Indonesia, Peru, the Russian Federation and the United States, to levels of more than 70 per cent in Latvia, Portugal, the Republic of Korea and Switzerland. *Ibid.*, p. 26.

⁷⁹ World Economic Forum, *The Future of FinTech: A Paradigm Shift in Small Business Finance*, (2015), p. 9.

⁸⁰ Inter-agency Task Force on Financing for Development (supra, footnote 24), p. 64.

⁸¹ IFC, *MSME Finance Gap* (supra, note 15), p. 44.

⁸² *Ibid.*

⁸³ European Investment Fund (supra, footnote 63), p. 62.

⁸⁴ IMF, *Financial Inclusion of Small and Medium-Sized Enterprises* (supra, footnote 49), p. 13.

⁸⁵ Inter-agency Task Force on Financing for Development (supra, footnote 24), p. 64.

services, and enhancing user experience through their digital interfaces.⁸⁶ Nevertheless, compared with larger enterprises, interest rates still remain high for MSMEs.⁸⁷

42. As discussed in paragraph 6 above, women entrepreneurs may face more difficulties in accessing credit in the form of traditional lending due to legal, institutional and socio-cultural 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.⁸⁸ 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, which further restricts their ability to obtain bank credit.⁸⁹ In some countries, there exists a mistrust among women with respect to banks post financial scandals and crises. Because of such constraints, the finance gap for women entrepreneurs in emerging markets is currently estimated at \$1.5 trillion.⁹⁰

F. Trade finance

43. Trade finance is the term used to describe the arrangements available to buyers (importers) and sellers (exporters) that are used to mitigate risks and ensure that the terms and conditions of an underlying commercial contract are met, so that the exporter receives payment and the importer receives the goods or services. A broad range of trade finance arrangements are available to all types of businesses, including MSMEs.

44. **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).⁹¹ 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.⁹² 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.⁹³ It was reported that in some jurisdictions post-dated cheques were used under factoring contracts to strengthen the enforceability of rights to payment.⁹⁴

⁸⁶ For example, Brazil, China, Germany and the United Kingdom. See OECD, *Financing SMEs and Entrepreneurs 2020* (supra, footnote 20), p. 50, box 1.2.

⁸⁷ 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.

⁸⁸ 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.

⁸⁹ IFC, *MSME Finance Gap*, (supra, note 15), p. 44.

⁹⁰ IFC and Goldman Sachs, *IFC and Goldman Sachs 10,000 Women: Investing in Women's Business Growth*, 2019, p. 4.

⁹¹ *UNCITRAL Legislative Guide on Secured Transactions, 2007*, para. 31.

⁹² 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 to SME and Entrepreneurship Financing: Broadening the Range of Instruments*, 2015, para. 97.

⁹³ IFC, *MSME Finance Gap* (supra, footnote 15), p. 45.

⁹⁴ 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

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.⁹⁵

45. **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.⁹⁶ It is likely to be used in relation to “open account” trade where the buyer and seller have an existing business relationship⁹⁷ 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 importers, exporters 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 exporters 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, forfaiting, distributor finance and pre-shipment finance),⁹⁸ 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.⁹⁹

46. Trade finance activities are usually covered by existing laws and regulations governing commercial contracts and dispute resolution, as well as certain specific legal or regulatory frameworks concerning the operation of banks or a particular type of trade finance (for example, factoring). The challenges faced by small and medium-sized enterprises to access trade finance 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.¹⁰⁰ The low share of MSME trade finance was partly explained by the higher risk perception and cost of doing business associated with MSME financing.¹⁰¹

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.

⁹⁵ The secretariat has added a reference to debt purchase as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 23).

⁹⁶ ICC, Standard Definitions for Techniques of Supply Chain Finance (2016).

⁹⁷ ICC Academy, “Supply Chain Finance: An Introductory Guide”, website, available at: <https://icc.academy/supply-chain-finance-an-introductory-guide>.

⁹⁸ Receivables discounting refers to the financing technique under which companies discount all or part of their receivables (represented by outstanding invoices) to a financier to provide a one-off cash injection for a particular purpose; forfaiting refers to the purchase of a future payment obligation without recourse; distributor finance is generally made available to the distributor of a large manufacturer to cover the holding of goods for resale and to bridge the liquidity gap until they receive funds following the sale of goods; and pre-shipment finance, also known as purchase order finance, is commonly provided against purchase orders on a transactional basis but can also be made against demand forecasts or underlying commercial contracts.

⁹⁹ OECD, New Approaches (supra, footnote 92), para. 92.

¹⁰⁰ 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.

¹⁰¹ ICC, 2018 Global Trade – Securing Future Growth, 2018, p. 98. Based on a World Trade Organization (WTO) report, 2016, it was estimated that half of SMEs’ trade finance requests globally were rejected, compared to only 7 per cent of finance requests sought by multinational companies. According to the International Chamber of Commerce (ICC), 2018, although SMEs accounted for more than 80 per cent of businesses in Africa, on average they represented only 28 per cent of the trade finance portfolios of banks. A more recent survey by the Asian Development Bank (ADB) (2019) indicated that SMEs accounted for 37 per cent of trade finance

For financiers, 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.

G. Corporate bonds

47. **Corporate bonds** are debt obligations issued by private and public enterprises, including some sophisticated mature medium-sized enterprises. By issuing corporate bonds, the enterprise makes a legal commitment to pay interest on the principal, independent of their performance, and to repay the principal when the bond matures. The issuer may have the option to buy back the bond before the maturity date.¹⁰² Corporate bonds can be either secured over specific assets or unsecured, and the credit quality of such bonds is often determined by credit rating agencies.¹⁰³ In most jurisdictions, enterprises (including mature medium-sized enterprises) that intend to issue corporate bonds must file a prospectus with the relevant authority (describing the financial conditions of the enterprise, the terms of the bond, the risks of investing, and how the enterprise plans to use the bond sale proceeds).

48. The issuance of corporate bonds is often dealt with in existing laws and regulations governing commercial contracts and dispute resolution, as well as certain specific legal or regulatory frameworks concerning issuances of securities. In some countries, the regulatory framework also allows private placements of corporate bonds, i.e. the offer of bonds to only a few selected investors by unlisted enterprises (including mature medium-sized enterprises). Private placements are subject to less stringent reporting requirements and do not need a formal credit rating. It is particularly relevant for larger and more mature medium-sized enterprises facing a major transition, such as a change in ownership, expansion into new markets and activities, or acquisitions.¹⁰⁴ Although the private placement market is well developed in the United States and Europe, it remains relatively underdeveloped in other regions of the world.¹⁰⁵

49. Similar to those challenges faced by mature medium-sized enterprises in relation to public listing, the issuance of corporate bonds is likely to be more burdensome for mature medium-sized enterprises than for larger firms due to the fixed costs of due diligence (the issuance costs may be as high as 10 per cent of the issued amount).¹⁰⁶ The disclosure and reporting requirements set out by relevant authorities also present challenges for many mature medium-sized enterprises lacking the expertise and experience in drafting prospectuses. The rigidity implied by the fixed schedule of interest and principal repayments may also discourage some mature medium-sized enterprises from issuing corporate bonds as such repayment schedule requires a relatively stable cash-flow pattern.¹⁰⁷

50. Notably, in the aftermath of the global crisis, as other financial sources became less available, some countries witnessed an increasing demand from medium-sized enterprises and investors for a corporate bond market.^{108 109}

demand based on the proposals received by banks surveyed worldwide (51 per cent for banks in Asia and the Pacific). The rejection rate of SME applications was much higher than multinational enterprises. See WTO, *Trade finance and SMEs: Bridging the gaps in provision*, 2016, p. 23; ADB, *ibid.*, p. 4.

¹⁰² OECD, *New Approaches* (supra, footnote 92), para. 177.

¹⁰³ *Ibid.*, paras. 181 and 182.

¹⁰⁴ OECD, *Financing SMEs and Entrepreneurs 2020* (supra, footnote 20), pp. 42–43.

¹⁰⁵ *Ibid.*

¹⁰⁶ OECD, *New Approaches* (supra, footnote 92), para. 191.

¹⁰⁷ *Ibid.*

¹⁰⁸ *Ibid.*, para. 451.

¹⁰⁹ The secretariat has inserted this sentence to refer to issues relevant for medium-sized enterprises as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 26).

Note to the Working Group: The Working Group may wish to consider whether: (i) there are any other commercial laws and regulations that govern the debt tools mentioned above; and (ii) there are any other debt tools relevant for MSME access to credit but not subject to any existing legal frameworks that provide certainty, clear allocation of risks for both financiers and MSMEs and are conducive for MSME access to credit.

H. A legislative framework supportive of debt tools for MSME access to credit

51. As illustrated above, financiers tend to impose collateral or guarantee requirements on MSMEs applying for credit (including, but not limited to, bank credit, trade finance, and microcredit), which give financiers some comfort in light of the low creditworthiness of some MSMEs. Collateral or guarantee is not considered as a debt tool as such, but a credit enhancement tool which can be used for any type of debt. Generally, enhanced legal frameworks 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 sub-section discusses a number of suggested improvements to existing legal frameworks 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

52. 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. 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.¹¹⁰ In light of a reduced risk, creditors are more likely to be willing to extend affordable credit.

53. 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 MSMEs¹¹¹

54. 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 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.

55. 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

¹¹⁰ UNCITRAL Legislative Guide on Secured Transactions (supra, footnote 91), p. 2.

¹¹¹ The secretariat has revised (i) the title of this subsection, and (ii) this subsection to focus on three criteria for a secured transaction regime that facilitates credit for MSMEs as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 32).

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.

56. 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.¹¹² 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.¹¹³ Sample security agreements are provided in the *UNCITRAL Practice Guide to the Model Law on Secured Transactions* (the “Practice Guide”).¹¹⁴

57. 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.¹¹⁵ 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.¹¹⁶ 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 financier is financing its ongoing operation, it suffices to conclude a single-document and all-asset security agreement should be permitted.¹¹⁷

58. 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.¹¹⁸ 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.¹¹⁹

59. 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 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.¹²⁰ A secured transaction regime that facilitates credit for MSMEs should include clear

¹¹² UNCITRAL Practice Guide to the Model Law on Secured Transactions, para. 11.

¹¹³ *Ibid.*, para. 12.

¹¹⁴ The secretariat has included an explicit reference to the Practice Guide as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 31).

¹¹⁵ The secretariat has revised this sentence to include digital assets as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 32).

¹¹⁶ UNCITRAL Practice Guide (supra, footnote 112), paras. 35 and 36. For a lease that does not function as security right, please refer to the Unidroit Model Law on Leasing, 2008.

¹¹⁷ *Ibid.*, p. 81.

¹¹⁸ *Ibid.*, para. 305.

¹¹⁹ *Ibid.*, para. 304.

¹²⁰ UNCITRAL Legislative Guide on Secured Transactions (supra, footnote 91), p. 189.

priority rules that lead to predictable outcomes in any competition between claimants to the encumbered assets.¹²¹ 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.¹²²

Note to the Working Group: The Working Group may wish to consider whether to recommend the use of existing international standards concerning the use of movable assets as collateral as discussed above.

(ii) *Key features of an efficient registry system*¹²³

60. 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 right that does not require the secured creditor to take possession of the assets and allows 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.¹²⁴ This priority rule provides financiers with certainty, thus encouraging the granting of credit to MSMEs.

61. 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.^{125,126} Firstly, the legal and operational guidelines governing registry services, including registration and searching, should be simple, clear and certain from the perspective of all potential users.¹²⁷ 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.¹²⁸ 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.¹²⁹ Such “notice registration” system reduces transaction costs for registrants.¹³⁰

62. 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.¹³¹ Furthermore, access to registry services should also be electronic so as to permit users to submit notices and

¹²¹ Ibid.

¹²² Ibid., recommendation 76 (a).

¹²³ The secretariat has revised (i) the title of this subsection, and (ii) this subsection to highlight three main elements (i.e., the need for registration of non-possessory security rights, explanation of the priority rules, guidance on how to design an efficient registry system) as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 33).

¹²⁴ UNCITRAL Model Law on Secured Transactions: Guide to Enactment, para. 143.

¹²⁵ 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.

¹²⁶ The Secretariat has included an explicit reference to the UNIDROIT Guide on Best Practices for Electronic Collateral Registries as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 31).

¹²⁷ UNCITRAL Guide on the Implementation of a Security Rights Registry, para. 10.

¹²⁸ Ibid.

¹²⁹ Ibid., para. 57.

¹³⁰ Ibid., para. 59.

¹³¹ Guide to Enactment (supra, footnote 124), para. 145.

search requests directly over the Internet or via networking systems.¹³² 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.¹³³

Note to the Working Group: The Working Group may wish to consider whether to recommend the use of existing international standards concerning efficient security rights registry systems as discussed above.

(b) Immovable assets as collateral

63. The paragraphs below discuss (i) legalization of property rights over immovable assets and (ii) key features of an efficient legal framework, drawn from the guidance provided in the European Bank for Reconstruction and Development (EBRD) Core Principles for a Mortgage Law.

(i) Legalization of property rights over immovable assets

64. 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 economies 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.¹³⁴ For 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.

65. 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, financiers may accept a simple certificate of customary interests and rights in land (rather than a formal ownership certificate) as collateral. Recent land reforms¹³⁵ 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.¹³⁶

66. 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

¹³² Ibid., para. 146.

¹³³ 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.

¹³⁴ Making the Law Work for Everyone, Volume I Report of the Commission on Legal Empowerment of the Poor (2008), pp.6–7.

¹³⁵ For example, Ghana.

¹³⁶ IFC (supra, footnote 75), p. 9.

certification systems, recognition of community forest rights and community-based management of land.¹³⁷

67. 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.¹³⁸

(ii) *Key features of an effective legal framework*¹³⁹

68. Facilitating access to credit could be regarded as the primary objective of modernising the legal framework for secured transactions involving immovable assets. 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 more antiquated system with specific types of security interest for specific assets. Arguably, the functional and unitary approach adopted by the *Model Law on Secured Transactions*¹⁴⁰ could 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.

69. 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 (i) 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.¹⁴¹

70. 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

¹³⁷ 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.

¹³⁸ Making the Law Work for Everyone (supra, footnote 134), p. 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 its report “Making the Law Work for Everyone”. Work on legal empowerment of disadvantaged people is carried on by UNDP.

¹³⁹ The secretariat has revised this sub-section to discuss that in a legal framework that enables using immovable assets as collaterals it should be (a) easy to create security rights, (b) easy to enforce security rights, and (c) easy to assess the ranking of claims, as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 35).

¹⁴⁰ 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).

¹⁴¹ EBRD Core Principles for a Mortgage Law, Principles 2, 7 and 10.

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 realisation. 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 realisation at market value of the mortgaged property. Delays in realisation are likely to bring uncertainty and increase costs. Any surplus proceeds beyond those needed for satisfying the secured claim should return to the mortgagor.¹⁴²

71. 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 mortgaged property.¹⁴³ 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.¹⁴⁴ 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 notarisation that the mortgage has been validly created, the registration process could be more simple and quick if registration is merely intended to publicise the mortgage claim.¹⁴⁵

Note to the Working Group: The Working Group may wish to identify any other existing international standards and possible areas for future improvement in context of using immovable assets as collateral as discussed above.

2. Possible areas for future improvement

(a) Use of collateral

72. The paragraphs below intend to identify possible areas for future improvement in the context of use of collateral to facilitate MSMEs' access to credit.

(i) Obstacles faced by MSMEs, particularly microenterprises

73. 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.¹⁴⁶ Despite the obvious advantages that businesses may benefit from the existence of a legal framework based on the Model Law, this by itself may not remove all of the obstacles that businesses may face in obtaining access to credit, in particular those faced by microenterprises as listed below.

Lack of collateral

74. Microenterprises face financing constraints as 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 the microenterprises. Many of them do not have the necessary amount and type of assets

¹⁴² Ibid., Principle 4.

¹⁴³ Ibid., Principle 9.

¹⁴⁴ EDRB, Mortgages in transition economies – The legal framework for mortgages and mortgage securities, p. 21.

¹⁴⁵ Ibid., p. 22.

¹⁴⁶ UNCITRAL Practice Guide (supra, footnote 112), para. 26.

that could serve as collateral. Household goods owned by microenterprises 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.

75. Microlenders sometimes may accept jewellery and even household furniture and appliances as collateral.¹⁴⁷ From the perspective of microlenders, these forms of collateral serve primarily to demonstrate the microenterprise's commitment, rather than as a secondary repayment source.¹⁴⁸

76. Collateral requirements under financial regulations are quite high worldwide for borrowers (including microenterprises). In Asia and the Pacific, financial regulations in many countries require collateral to be at least 125 per cent of loan value.¹⁴⁹ In other countries, collateral requirements are even higher and can be as high as 250 per cent of loan value.¹⁵⁰ 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.¹⁵¹ Compared with small and medium-sized enterprises, microenterprises are likely to have even less assets that could serve as collateral.

77. While high collateral requirements constrain microenterprises in accessing credit in general, in certain jurisdictions this issue is particularly significant for women entrepreneurs as any asset/property is often owned or registered in the spouse's name. In certain States, for example, unequal inheritance rights and work restrictions limit women's access to collateral.¹⁵² In the Middle East and North Africa region, female entrepreneurship rates are the lowest worldwide, partly due to women's limited rights to family assets for collateral and the associated difficulties in accessing credit.¹⁵³ In some States of that region, women do not have the right to administer marital property, including property that they brought into the marriage and property acquired during the marriage.¹⁵⁴

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

Asset valuation

78. Lending based on movable assets requires their valuation, which remains a rather complex process despite the existence of international standards.¹⁵⁵ In practice, there are many ways to determine the value of the assets to be encumbered 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 financier would expect to collect from the debtors of the receivables.¹⁵⁶ If the asset is inventory (e.g. clothing), its value will normally be calculated based on prices in the relevant secondary market.¹⁵⁷ The financier, however, may not 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 the asset at a substantially lower price.¹⁵⁸ Accordingly, the advance rates are calculated as a percentage of the assets' value (e.g. 40 per cent of the market value of the clothing inventory).

¹⁴⁷ ILO, Making Microfinance Work (supra, footnote 64), p. 120.

¹⁴⁸ Ibid.

¹⁴⁹ ADB, Thematic Evaluation: ADB Support for SMEs, (2017), p. 3, footnote 12.

¹⁵⁰ IMF, Financial Inclusion (see footnote 49), p. 16.

¹⁵¹ ADB, ADB Briefs No. 113 (supra, footnote 100), p. 5, figure 5.

¹⁵² ITC, Unlocking Markets (supra, footnote 22), p. 22.

¹⁵³ Ibid.

¹⁵⁴ World Bank, Secured Transactions (supra, footnote 61), p. 22.

¹⁵⁵ See www.ivsc.org/standards/international-valuation-standards/IVS.

¹⁵⁶ UNCITRAL Practice Guide (supra, footnote 112), para. 121.

¹⁵⁷ Ibid.

¹⁵⁸ Ibid., para. 122.

79. In general, creditors need to be able to make rational predictions as to how much can be realized from collateral(s) in the event of a default. The assessment of the value of asset is risky and expertise is thus essential and required for financiers to perform reliable valuations of the assets to be encumbered.¹⁵⁹ The value of certain assets – such as manufacturing and industrial equipment, and agricultural products – can be affected not only by their condition but also by market conditions and trends.¹⁶⁰ 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.¹⁶¹

80. For financiers lending to microenterprises, asset valuation presents more challenges because certain valuation methods may be too costly relative to the value of the asset. Leaving valuation of encumbered assets to financiers (rather than independent appraisers) seems to be a more efficient and less costly mechanism.¹⁶² As noted in the *Practice Guide*, it may also be particularly difficult to determine the value of the asset if it is a type that is not regularly traded in the given market.¹⁶³

Note to the Working Group: *The Working Group may wish to consider formulating a recommendation to address the issue of asset valuation for microenterprises as discussed above.*

Overcollateralization

81. Financiers may require microenterprises to provide collateral, the value of which significantly exceeds the amount of the loan (often referred to as “overcollateralization”).¹⁶⁴ There may be several reasons for doing so. For example, microenterprises often lack credit history and transaction records to show their creditworthiness. Financiers may not be equipped with cost-effective tools for risk assessment, especially when the requested loan amount is very small. However, overcollateralization may limit businesses from utilizing the maximum value of their assets to obtain secured credit from another financier using the residual value, which is possible under the Model Law so as to facilitating credit.¹⁶⁵

82. To address overcollateralization, courts in different jurisdictions have developed various solutions summarized as follows: (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.¹⁶⁶ It is worth noting that the *UNCITRAL Legislative Guide on Secured Transactions* 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.¹⁶⁷

83. The appropriate response to overcollateralization is likely to vary from State to State and may sometimes be addressed in other areas of law. For example, the law of some States may also provide for the reduction of the scope of assets that can be encumbered if their value substantially exceeds the amount of the secured obligation.¹⁶⁸

¹⁵⁹ The secretariat has inserted these two additional sentences as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 34).

¹⁶⁰ World Bank, *Secured Transactions* (supra, footnote 61), p. 104.

¹⁶¹ *Ibid.*

¹⁶² UNCITRAL *Legislative Guide on Secured Transactions* (supra, note 91), p. 70.

¹⁶³ UNCITRAL *Practice Guide* (supra, footnote 112), para. 123.

¹⁶⁴ In practice, overcollateralization may be in combination with requests for issuance of personal guarantees (see Chapter III, Section H.2 on personal guarantees for MSEs’ loans below).

¹⁶⁵ The secretariat has revised this paragraph to address concerns regarding a possible negative interpretation of granting security over all assets as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 34).

¹⁶⁶ UNCITRAL *Legislative Guide on Secured Transactions* (supra, note 91), p. 82.

¹⁶⁷ *Ibid.*, p. 83.

¹⁶⁸ UNCITRAL *Practice Guide* (supra, footnote 112), para. 25.

Note to the Working Group: *The Working Group may wish to consider formulating a recommendation to address the issue of overcollateralization for microenterprises as discussed above.*

Enforcement

84. In the event of default, a security right makes it possible for a financier to recover what it is owed from the value of the encumbered asset. For microenterprises, relevant legislation in some jurisdictions does not impose any limit on what can be seized by the secured creditor for enforcement. Importantly, essential personal assets would need to be protected and excluded from the scope of enforcement by relevant legislation, particularly in the context of a sole entrepreneur. The laws of some States 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. In the context of judicial enforcement processes, courts may have the power to impose certain protection on essential personal assets or up to a certain minimum amount of personal assets of microenterprise owners under relevant national laws. Difficulties faced by secured creditors regarding enforcement may discourage them from lending to MSMEs.

Note to the Working Group: *The Working Group may wish to consider formulating a recommendation to address the issue of enforcement of security rights for microenterprises as discussed above.*

(ii) *International instruments facilitating the use of certain movable assets as collateral*

85. The paragraphs below discuss several future international instruments facilitating the use of receivables and warehouse receipts as collateral, which are likely to be used by most MSMEs around the world during their ordinary course of business.

Receivables

86. Businesses (including MSMEs) often raise funds for their operations with the receivables that they generate, rather than waiting for the receivables to be paid. Sometimes they borrow money from a financier with the receivables serving as security for their obligations. As mentioned earlier, it should be possible for an MSME (acting as “grantor”) to grant a security right in almost any type of movable asset, including receivables. Sometimes they also transfer ownership of the receivables to a financier outright, usually at a discount. The latter type of a financier is often referred to as a “factor”.¹⁶⁹ In transactions involving an outright transfer of receivables, all economic benefits and risks are transferred to the factor. If more is collected from the receivables than what the factor paid for them, the factor retains the benefit. Similarly, if there are receivables that cannot be collected, the loss is borne by the factor, unless agreed otherwise (which is referred to as “recourse factoring”).¹⁷⁰

87. Recognizing the large volume of factoring transactions and the absence of a harmonized text to assist States in related domestic law reforms, the UNIDROIT Governing Council approved in 2019 the project for a UNIDROIT Model Law on Factoring, which is still work in progress.^{171,172} The Model Law on Factoring would

¹⁶⁹ Ibid., para. 79.

¹⁷⁰ Ibid., para. 85.

¹⁷¹ A working group has been established since 2020 to discuss a preliminary draft of the Model Law, the latest version of which (dated November 2021) addresses issues concerning transfers of receivables, making a transfer of a receivable effective against third parties, the registry system, rights and obligations of the parties (including transferor and transferee, and debtor), collection and enforcement as regards outright transfers and security transfers, as well as conflict of laws. See Study LVIII A – W.G.4 – Doc. 3.

¹⁷² For more information about the project, see www.unidroit.org/work-in-progress/factoring-model-law/. It is worth noting that Unidroit has already developed the *UNIDROIT Convention on International Factoring* (1988), which entered into force in 1995.

aim to assist States that want to introduce a new factoring law or update their secured transactions framework but are not yet in a position to undertake a comprehensive reform involving all types of movable assets. The Model Law on Factoring builds on the UNCITRAL texts on secured transactions including the Receivables Convention and the Model Law, and could help remove impediments to the use of factoring (e.g. perfection requirements, anti-assignment clauses, preferential treatment for certain parties, and enforcement)¹⁷³ and lower the cost of factoring.

Warehouse receipts

88. Warehouse receipts have become increasingly important in supply-chain and value-chain financing, both locally and globally. Yet, there is a lack of norms governing warehouse receipts in many jurisdictions concerning, for example, the issuance and transfer of warehouse receipts, the duties and rights of issuers and holders, and the allocation of losses in case of a shortage of stored assets. This places constraints in the sale of warehouse receipts as well as their use as collateral for loans, thereby restricting access to credit and limiting economic growth. Currently, no international standards exist that would assist States in undertaking reforms regarding the use of warehouse receipts. It was suggested that a certain level of harmonization could facilitate the use of warehouse receipts, in particular across sectors and in the cross-border context.¹⁷⁴

89. In 2020, UNCITRAL and Unidroit commenced a joint project on the development of a Model Law on Warehouse Receipts which is still work in progress, focusing on the private law aspects of warehouse receipts.¹⁷⁵ Notably, a well-designed warehouse receipt system can provide benefits for all participants in the commodity market, including facilitating access to credit and lower its cost by creating secure collateral, thereby attracting private sector investments to a particular sector. An effective warehouse receipt system also allows for smallholders (such as MSMEs) to participate in commodity markets by providing them with the possibility to consolidate their produce and sell jointly further down the value chain.¹⁷⁶

Note to the Working Group: (i) *The Working Group may wish to identify any other international instruments being developed that are relevant to the use of collateral.*

(ii) *Encumbrances on immovable property are, in principle, excluded from the scope of the UNCITRAL texts on secured transactions. The Working Group may wish to consider the desirability of offering guidance on this topic within the context of MSME access to credit. The Working Group may also wish to consider drawing, as appropriate, on the relevant recommendations and guidance from existing UNCITRAL texts on secured transactions and other existing international legal standards that might be relevant.*

(b) Personal guarantees for MSEs' loans

90. The paragraphs below intend to identify possible areas for future improvement in the context of issuing personal guarantees for MSEs' loans either based on current best practices implemented in different States or on the UNCITRAL work on MSE's insolvency.

91. Financers often demand personal guarantees from MSMEs requesting a loan, in particular MSEs, to reduce their risk in lending, since the guarantees create an additional obligation by a third person (i.e. the guarantor) that is distinguishable from the main obligation of the debtor. The guarantor will repay the debtor's obligation if

¹⁷³ Summary Report of the First Session of Unidroit Factoring Model Law Working Group, Study LVIII A-W.G.1 – Doc.4 rev.1 (August 2020), para. 9.

¹⁷⁴ A/CN.9/1066, para. 5.

¹⁷⁵ A Unidroit working group has been established since 2020 to develop draft text of a Model Law on Warehouse Receipts. The latest version of the draft text (dated August 2021) addresses issuance of a warehouse receipt, transfer of warehouse receipts, protected holders and other transferees, warranties and so on. See Study LXXXIII – W.G.3 – Doc.3.

¹⁷⁶ For more information, see www.unidroit.org/work-in-progress/model-law-on-warehouse-receipts/#1488897069871-af7a84cf-bd9a.

the latter fails to perform and will likely become subrogated to the creditors' rights against the business including the right to enforce the loan. If the guarantor cannot repay the MSE's loan, the financiers may seize any of its private assets (unsecured guarantees) or only the specific assets against which the guarantee is raised (secured guarantee).¹⁷⁷

92. While a request for personal guarantees may be more common when collateral assets are not available at the level required by the financiers' risk assessment, so that the personal guarantees supplement the collateral's gap, financiers 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.^{178, 179} Provision of personal guarantees may result in a considerable improvement of the loan conditions, such as ensuring a lower interest rate, a larger loan amount or a longer payoff term. Securing financing that would otherwise be out of reach for many MSEs may help them 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 otherwise be too large for the financier to accept it. 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 other business for the supply of goods or services.¹⁸⁰

(i) *A general introduction to dependent and independent personal guarantees*

93. In many legal traditions, personal guarantees are grouped into two general categories depending on the link between the guarantee and the underlying contractual relationship.¹⁸¹ Under the first category (independent guarantees), where the guarantee is independent from the underlying contractual relationship, the 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).¹⁸² 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).¹⁸³

94. 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

¹⁷⁷ The secretariat has revised the two opening paragraphs of this section (paras. 98 and 99 of A/CN.9/WG.I/WP.124), including reversing their order, for improved coherence of text.

¹⁷⁸ In certain countries, merchant cash advance is an alternative option to personal guarantees and collateral where the financier 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/.

¹⁷⁹ The secretariat has added reference to the role of personal guarantees in reducing financiers' risk and cost of credit as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 36).

¹⁸⁰ The secretariat has included this reference in keeping with the deliberations of the Working Group at its thirty-sixth session (A/CN.9/1084, para. 41).

¹⁸¹ M. Damjan, A. Vlahek, The protection of consumers as personal security providers under the DCFR and EU consumer law, 2018, p. 21, available at: www.researchgate.net/.

¹⁸² See also the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 1995).

¹⁸³ M. Damjan, A. Vlahek, The protection of consumers (supra, footnote 181), p. 24.

performance after their payment if the secured claim has been held invalid or unenforceable).¹⁸⁴ Small 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.¹⁸⁵ 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 Conventions 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.

95. 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.¹⁸⁶ Therefore, the creditor may request repayment from the principal debtor first (however, see para. 101), and the guarantor, once requested to pay, can refer to all defences that the principal debtor has against the creditor.¹⁸⁷

96. As noted above (see para. 94), 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 financiers who are the owners, directors, 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 financiers and the MSEs, since they indicate to the financiers 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.¹⁸⁸

(ii) *The relevance of dependent personal guarantees for MSEs*

97. Although, issuing a personal guarantee for a business loan is common for many MSEs across different regions of the world,¹⁸⁹ personal guarantees may weaken the limited liability nature of the MSE, when the business is incorporated. 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 guarantors¹⁹⁰ and their households and in some countries this may lead to strong social stigma. To mitigate the risks of overindebtedness and respond to the need of credit by MSEs, the use of surety bonds issued by authorized

¹⁸⁴ 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. Verschaegen, eds.), 2017, p. 375.

¹⁸⁵ The secretariat has revised the second part of this paragraph (para. 100 of [A/CN.9/124](#)) to clarify the different use of personal guarantees by different types of small businesses as requested by the Working Group at its thirty-sixth session (para. 37, [A/CN.9/1084](#)).

¹⁸⁶ 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.

¹⁸⁷ M. Damjan, A. Vlahek, *The protection of consumers* (supra, footnote 181), p. 23.

¹⁸⁸ T. Wolff, *Look before you sign... the pitfalls of personal guarantees*, 2018, available at: www.natlawreview.com/article/look-you-sign-pitfalls-personal-guaranties.

¹⁸⁹ 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*.

¹⁹⁰ 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.

companies (usually insurance companies) is increasing in several countries. Surety bonds have the same scope of personal guarantees, but in case of inability of the principal debtor to fulfil its obligation, the surety company will intervene and arrange for performance or payment. Surety bonds do not require collateral and are usually available at a lower cost than a personal guarantee.

Note to the Working Group: *In the next iteration of the Future Text, the secretariat will further elaborate on the topic of surety bonds, in particular it will research whether best practices exist that make the MSME market attractive for surety bonds' providers.*

(iii) *Criteria for a personal guarantee regime that facilitates credit for MSMEs*

98. A legal regime that equally protects the rights of the guarantors and the financiers and does not discourage the latter from providing credit is nevertheless key. Most States do not seem to have a specific regime on guarantees for small business loans and general guarantees' law thus apply. However, several features of general guarantees' regimes, such as form of the contract, nature and scope of the guarantor's liability, financiers' duties of disclosure of information, enforcement of the guarantee, are equally relevant for guarantees provided for small businesses' loans. Instead, not many countries seem to have specific provisions on the guarantees issued by family members of the MSE's owners or directors or other persons closely related to them (see paras. 109 to 111).

a. Form of the personal guarantee

99. It is important that guarantors are aware of the risks when they agree to take up 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.¹⁹¹ To minimize risks relating to the guarantor's lack of awareness, most States require 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,¹⁹² an intention to be legally bound and the guarantor's signature.¹⁹³

100. To further minimize the risks of unawareness, other States have established additional safeguards such as an explicit declaration of responsibility by the guarantor,¹⁹⁴ 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);¹⁹⁵ or that the guarantors acknowledge their obligation under the guarantee before a lawyer, who must then confirm the acknowledgement by endorsement on the

¹⁹¹ 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.

¹⁹² 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. Schwartz, *Personal Guarantees* (supra, footnote 184), p. 376.

¹⁹³ L. Ellis, *Where are the loopholes in Guarantees?*, 2019, in <https://hallellis.co.uk/unenforceable-guarantees-legal/>.

¹⁹⁴ For example, Poland as cited in A. Schwartz, *Personal Guarantees* (supra, footnote 184), p. 376.

¹⁹⁵ For example, Japan.

guarantee agreement.^{196,197,198} Balanced domestic regimes also ensure transparency and legal certainty for both the financier and the guarantor by clearly establishing the moment at which the offer of a guarantee becomes effective.¹⁹⁹

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. Legal nature and scope of the liability

101. The legal nature of the guarantor's liability may affect the extent to which the guarantor is protected against the financier's claim of performance. In the case of subsidiary liability, the financier must first request the principal debtor to perform its obligation before requesting the guarantor, although in certain States the parties can agree that the financiers seek direct repayment from the guarantor.²⁰⁰ If joint and several liability (also known as "solidary" liability) is established, the financier 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 financiers for the repayment of the MSE's debt. This type of clauses 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.

102. Given the different extent of protection, it would thus be desirable for the domestic law to specify whether a presumption of subsidiarity or solidarity of the liability exists – for example, in one State the law imposes "joint and several liability" when the guarantee is silent in this respect²⁰¹ – and whether the presumption of liability is mandatory or can be modified by the parties and by which means (i.e. explicit agreement). The legislature may also consider requiring the parties to expressly agree on the nature 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 financiers 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.²⁰²

103. As to the scope of the guarantor's liability, this could be limited to a particular period or amount of debt,²⁰³ or not. A guarantee that is not limited in time or amount

¹⁹⁶ For example, the Canadian province of Alberta.

¹⁹⁷ The secretariat has deleted reference to France from the paragraph (para. 105 of A/CN.9/WG.I/WP.124) as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 38) since it was noted that the principle of proportionality was only applicable in certain cases.

¹⁹⁸ It should be noted that in many States 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 184), p. 379.

¹⁹⁹ The Secretariat has deleted reference to French legislation in the context of personal guarantees of owners and directors of MSEs as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 38) and has moved the discussion on treating guarantees of owners or directors as consumers' guarantees (supra, in footnote 198) as suggested by the Working Group. The secretariat has further revised the paragraph by deleting references to laws of other countries.

²⁰⁰ See A. Schwartze, Personal Guarantees (supra, footnote 184), p. 375.

²⁰¹ For example, North Carolina as cited in T. Wolff, in The National Law Review (supra, footnote 188).

²⁰² See A. Schwartze, Personal Guarantees (supra, footnote 184), p. 375.

²⁰³ See M. Damjan, A. Vlahek (supra, footnote 181), p. 39.

may be particularly risky for an MSE's guarantor as the guarantor may become liable for multiple MSE's loans with the same financier without appreciating that its personal liability is increasing. Moreover, the guarantor may also be held liable for loans taken by the MSEs after the guarantor is no longer an MSE's member. It is therefore desirable for the domestic law to require an explicit agreement between the financier and the guarantor in the case of unlimited guarantees. Further, the law could permit the financier and guarantor to agree that a guarantor who is no longer a member of an MSE be released from its obligation or replaced by a new guarantor. Similarly, in the case of the guarantor's death, the successor(s) should be permitted to obtain a release from the financier in order to avoid liability for an obligation they did not assume.

104. The law should also 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 financier against the principal debtor. 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.

***Note to the Working Group:** The Working Group may wish to consider formulating a recommendation to address the legal nature and scope of the guarantor's liability in the context of personal guarantee as discussed above.*

c. Pre-contractual and contractual duty of disclosure of information

105. 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.²⁰⁴ 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, depending on the length of the guarantee, throughout its term.

106. In several countries, financiers 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 useful 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 financier should obtain the MSE's consent for disclosure.²⁰⁵ To ensure that the guarantor is fully aware of the potential risks of the guarantees, in some countries the financier advises the guarantor to seek independent legal and financial advice on the effects of the guarantee. As noted below (see chapter VI, section G on safeguards against unfair practices), 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 financiers.

107. In order to be reminded of the long-term commitment and its potential risk, the guarantor should receive regular communication during the guarantee period about the state of the guarantee, including both the principal obligation and any other ancillary obligations linked to it (see para. 104). 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 financiers (for example, by simply requesting information on an annual basis).

108. To maximize its effects, the duty of disclosure should be complemented by a risk-warning duty, so that the guarantor should be immediately notified of any circumstances that may affect its obligation to perform, such as the MSE's default. Again, States may clarify the content of the risk-warning in their legislation which should at least include information about the secured amount of the principal

²⁰⁴ Ibid., p. 20.

²⁰⁵ Ibid., p. 35.

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.²⁰⁶

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.*

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

109. As noted above, when the personal guarantee is provided by the MSE's owner or a member of its family (often the spouse), 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 or directors. 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.

110. For the MSE owner to issue a personal guarantee, it seems quite common in many countries to require financiers to explain the consequence of such guarantee to the spouse of the MSE owner or even obtain the written consent of the spouse before issuance.²⁰⁷ 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 by a business owner or a company director.²⁰⁸

111. 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 their 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. In some countries, courts protect those vulnerable guarantors applying the doctrines of violation of fiduciary relationship, or unconscionability²⁰⁹ or undue influence whose application is not limited to personal guarantees. The importance to ascertain that the guarantor is acting on the basis of adequate and neutral information has also been noted and it has been suggested that the financier 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.²¹⁰ In certain countries, the courts have held that it is illegal for a financier to require a spousal guarantee for the sole reason that the prospective guarantor is married to the person seeking the loan.²¹¹

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, directors or family members as discussed above.*

²⁰⁶ See for instance *Manulife Bank of Canada v. Conlin*, [1996] 3 S.C.R. 415.

²⁰⁷ For example, Austria, Brazil, the Netherlands and Switzerland as referred to in A. Schwartz, *Personal Guarantees* (supra, footnote 184), p. 380.

²⁰⁸ For example, the Netherlands, available at: www.vandoorne.com/en/knowledge-sharing/blog/spousal-permission-needed-for-guarantee/, and Turkey, available at: <https://ongorenlaw.com/the-consent-of-the-spouse-will-not-be-needed-in-regard-to-the-guarantee-agreement/>.

²⁰⁹ 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.

²¹⁰ See M. Damjan, A. Vlahek (supra, footnote 181), pp. 35-36.

²¹¹ See for example *Hawkins v. Community Bank of Raymore* (United States Court of Appeals for the Eighth Circuit and Supreme Court).

e. Enforcement of the guarantee

112. 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 States, 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.²¹² 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.²¹³ However, not all countries have adopted personal insolvency laws, and some of those that implement them may have no discharge mechanisms or have a long waiting period before discharge, as well as heavy penalties for personal bankruptcy.²¹⁴

113. 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 the adoption of 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's 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.²¹⁵

114. 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. 111 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.*

Note to the Working Group: *The Working Group may wish to identify other possible areas for future improvement to facilitate the use of debt tools for MSMEs to access credit.*

²¹² D. Hahn, "Velvet Bankruptcy", in *Theoretical Inquiries in Law*, 2006, vol. 7, p. 541.

²¹³ *Ibid.*, p. 540.

²¹⁴ World Bank, *Report on the Treatment of MSME Insolvency*, 2017, p. 34.

²¹⁵ A/CN.9/1052, annex, para. 93 and A/CN.9/WG.V/WP.172/Add.1, paras. 330 to 335.

IV. Equity tools for MSMEs to access credit

115. This section lists various equity tools in the market for MSMEs to access credit (e.g. family and friends support, business angel investment, venture capital, and public listing on stock exchanges), identifies existing frameworks relevant to commercial law and analyses the challenges faced by MSMEs and financiers when using these tools.

A. Family and friends support

116. Microenterprises often rely on family and friends for initial capital.²¹⁶ As noted above, according to a survey of CGAP it is common for small businesses to borrow money from family and friends.²¹⁷ As mentioned above (see para. 27), family and friends support can come in the form of debt, equity or guarantee. Equity is usually associated with decision-making rights in the business. Sometimes family and friends may prefer equity investment in MSMEs at initial stages because they are part of the entrepreneur's close social network. They do not have the same concerns as professional investors in terms of risk assessment.²¹⁸ For MSMEs at initial stages, the amount of funds raised through family and friends in some countries generally exceeds other private equity sources (e.g. VC and business angel investments).²¹⁹ In developing countries, it is likely that MSMEs rely more on family and friends.²²⁰

117. Equity investments from family and friends are generally subject to existing legal frameworks relevant to commercial law governing 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). Support from family and friends is rarely a guaranteed source of financing for all types of businesses. In this regard, the MSME financing sector does not face challenges substantially different from those faced by large firms, except that MSMEs are more vulnerable economically, more dependent on such financing and may be less aware of their rights and obligations in relation thereto.

B. "Business angel" investment

118. "Business angel" investment²²¹ 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.²²² Business angel investment is a valuable source of funds for MSMEs, especially those that are not yet ripe for VC funding.²²³ Business angel investors²²⁴ are usually actively involved in business management, and can offer business

²¹⁶ Inter-agency Task Force on Financing for Development (supra, footnote 24), p. 67; UNESCAP, Small and Medium Enterprises Financing (supra, footnote 59), p. 3.

²¹⁷ CGAP, Executive Summary (supra, footnote 60), p. 15.

²¹⁸ Ibid., p. 24.

²¹⁹ For example, the United States. Ibid., 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.

²²⁰ ITC, SME Competitiveness Outlook 2019 (supra, footnote 25), p. 21.

²²¹ 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).

²²² OECD, New Approaches (supra, footnote 92), para. 332.

²²³ 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 24), p. 67.

²²⁴ 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.²²⁵ 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.²²⁶

119. 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. Similar to family and friends support, business angel investment is rarely a guaranteed source of financing for all types of businesses. Business angel investors typically invest in early-stage, innovative MSMEs.²²⁷ 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 angel investors to invest in MSMEs in certain countries.²²⁸

C. Venture capital

120. As a form of private equity, VC is an important source of funds for MSMEs in 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).²²⁹ In addition to start-ups, VC fund managers also provide funding to an operating enterprise.²³⁰

121. 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.²³¹ Moreover, fund managers in Europe identified the exit environment (including the validity and enforceability of exit clauses), fundraising, high investee company valuations and the limited number of high-quality enterprises to be the biggest challenges in the VC business in general, which also applies to the MSME sector.²³²

122. In some economies, the underdevelopment of private equity markets constitutes the main challenge for the MSME financing sector to mobilize VC funds. 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.²³³ The lack of an enabling regulatory framework, training and industry data also discourages VC investments in these countries.²³⁴

²²⁵ OECD, *Financing SMEs and Entrepreneurs 2020* (supra, footnote 20), p. 43.

²²⁶ European Investment Fund (supra, footnote 63), p. 32.

²²⁷ OECD, *Financing SMEs and Entrepreneurs 2020* (supra, footnote 20), p. 43.

²²⁸ OECD, *New Approaches* (supra, footnote 92), para. 405.

²²⁹ Inter-agency Task Force, *Financing for Sustainable Development* (supra, footnote 24), p. 67.

²³⁰ European Investment Fund, (supra, footnote 63), p. 25.

²³¹ ITC, *SME Competitiveness Outlook 2019* (supra, footnote 25), p. 25.

²³² EIF, *EIF VC Survey 2019 – Fund managers' market sentiment and policy recommendations*, 2019, p. iv.

²³³ Inter-agency Task Force on Financing for Development (supra, footnote 24), p. 67.

²³⁴ ITC, *SME Competitiveness Outlook 2019* (supra, footnote 25), p. 27.

D. Public listing on stock exchanges

123. Public listing on stock exchange markets could play a significant role in countries that have developed specialized stock markets for mature medium-sized enterprises.²³⁵ As part of the listing process, enterprises are usually required to disclose basic information about their activities and financial situation through a prospectus. Once listed, they are requested to provide regular disclosure and trading takes place under rules and procedures set out by the respective stock exchanges.²³⁶ Public listing may allow mature medium-sized enterprises to attract external financing, improve their creditworthiness, and enhance brand recognition and visibility. In turn, this could open up other sources of finance.²³⁷ Specialized stock markets are important for the development of capital markets for mature medium-sized enterprises.²³⁸ Compared to the main stock exchanges, specialized platforms could offer reduced listing fees and discounts on annual fees, relaxed entry requirements, business development assistance, or less frequent reporting requirements.²³⁹

124. As a highly regulated market, public listing on stock exchanges is subject to specific regulations which impose various disclosure, reporting and other obligations on the issuer. Issues covered in the prospectus are usually subject to existing laws and regulations governing commercial contracts. Due to the fixed costs of due diligence and listing, the process of public listing at main stock exchanges is typically less affordable for mature medium-sized enterprises than for larger firms. Other than costs, the disclosure and reporting requirements set out by these main stock exchanges also present challenges for many mature medium-sized enterprises. Despite the remarkable growth in specialized platforms worldwide, low-income countries have significantly fewer specialized platforms than high-income countries.²⁴⁰ Furthermore, in many instances, socioeconomic and cultural factors as well as management practices either discourage, prevent or make mature medium-sized enterprises reluctant to consider public listing (e.g. poor or limited knowledge about the listing processes and limited access to legal advice, cost of acquiring such knowledge or advice, low confidence towards the listing process, fear of being exposed to or vulnerability to stock price volatility, reluctance to share sensitive information, and concerns for the loss of control implied by the wider equity ownership).²⁴¹ As a result, the market in some countries is more oriented to financing through the banking sector than through public listing. In addition, undervaluation of enterprises and lack of specific regulations also presented several limitations.²⁴² Last but not least, in some jurisdictions the different tax treatment between equity and debt financing negatively affects the development of public equity markets for mature medium-sized enterprises.²⁴³

Note to the Working Group: *The Working Group may wish to consider whether: (i) there are any other commercial laws and regulations that govern the equity tools mentioned above; and (ii) there are any other equity tools relevant for MSME access to credit but not subject to any existing legal frameworks that provide*

²³⁵ Ibid., p. 13, box 3.

²³⁶ OECD, New Approaches (supra, footnote 92), para. 413.

²³⁷ OECD, Financing SMEs and Entrepreneurs 2020 (supra, footnote 20), p. 44.

²³⁸ Several jurisdictions have laid down special regulatory frameworks for SME stock exchanges with relaxed conditions for public listing, including the United Kingdom (AIM), Canada (TSXV), Hong Kong, China (GEM), Japan (Mothers), the Republic of Korea (KOSDAQ) and the United States (NASDAQ).

²³⁹ UNCTAD and World Federation of Exchanges, The Role of Stock Exchanges in Fostering Economic Growth and Sustainable Development, 2017, p. 12.

²⁴⁰ Ibid., p. 13.

²⁴¹ OECD, New Approaches (supra, footnote 92), para. 426.

²⁴² The secretariat has inserted this sentence as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 25).

²⁴³ OECD, New Approaches (supra, footnote 92), para. 429.

certainty, clear allocation of risks for both financiers and MSMEs and are conducive for MSME access to credit.

E. A legislative framework supportive of equity tools for MSME access to credit

125. While most of the challenges faced by MSMEs and financiers when using equity tools would require attention through policy, taxation and regulatory measures, corporate law play an important role in providing incentives for equity investment. This sub-section will discuss suggested improvements to existing legal frameworks concerning corporate governance that offers limited liability protection to investors and imposes record-keeping requirements.²⁴⁴

126. The *UNCITRAL Legislative Guide on Limited Liability Enterprises* (the “LLE Guide”), adopted in July 2021, distils good practices and key principles concerning simplified business forms into a series of recommendations on how a State could devise and regulate a simplified legal form for MSMEs that can best facilitate their success and sustainability, stimulate entrepreneurship and promote participation and the creation of value in the economy. 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.²⁴⁵

127. Particularly relevant for MSME access to credit is the recommendation in the LLE Guide to grant legal personality to the LLE so that it can become a legal entity separate from its members.²⁴⁶ As an essential consequence of the LLE’s legal personality, its members are not personally liable for its obligations and debts solely by reason of being members of the LLE.²⁴⁷ Limited liability permits entrepreneurs (including the MSME owner and the equity investor) to take business decisions without concern that they may jeopardize their personal assets if the business entity does not perform well or becomes involved in legal disputes. This is important both for the protection of the members of the organization and for the promotion of innovation and business creation, as it allows entrepreneurs to take business risks without fear of being personally liable for the possible failure of the organization.²⁴⁸ The presence of such a liability shield generally protects the members of an LLE from incurring direct or indirect personal liability as a result of the activities of the LLE. In effect, the financial liability of a member of the LLE is limited to a fixed sum, usually the value of the member’s contribution to the LLE. Such limited liability feature could help attract equity investors. Limited liability of members and distinct legal personality of the organization often go hand in hand. Granting both attributes to the LLE will assist in promoting the stability of the organization and access by it to lower cost credit.²⁴⁹

128. Last but not least, the LLE Guide recommends that the LLE 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 LLE.²⁵⁰ Building a good record of information concerning the LLE, particularly financial statements and other records of finances of

²⁴⁴ The secretariat has added this new section on business formation as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 61).

²⁴⁵ UNCITRAL Legislative Guide on Limited Liability Enterprises, para. 4. (To be published soon).

²⁴⁶ Ibid., recommendation 3. (To be published soon)

²⁴⁷ Ibid., recommendation 4. (To be published soon)

²⁴⁸ Ibid., para. 32. (To be published soon)

²⁴⁹ Ibid., para. 33. (To be published soon)

²⁵⁰ Ibid., recommendation 30. (To be published soon)

the LLE, could help attract future equity investors in the light of the increased credibility of the LLE and reduced costs associated with due diligence.

***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 discussed above, and (ii) identify other possible areas for future improvement to facilitate the use of equity tools for MSMEs to access credit.*

V. FinTech tools for MSMEs to access credit²⁵¹

129. This section lists various FinTech tools in the market for MSMEs to access credit (e.g. peer-to-peer lending, investment-based crowdfunding, electronic commerce platforms, blockchain applications), identifies existing frameworks relevant to commercial law and analyses the challenges faced by MSMEs and financiers when using these tools.

A. Introduction

130. 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 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.

131. The delivery of these new digital financial products relies in particular on new players such as mobile network operators (MNOs), financial technology (FinTech) firms, and large information and communication technology companies (BigTech) firms.²⁵² MNOs are large telecommunications service providers that are also licensed to offer e-money services through mobile phones and mobile telephone networks.²⁵³ At least in one country MNOs have recently developed digital credit products.²⁵⁴

²⁵¹ The secretariat has adjusted the focus of this Chapter on FinTech tools (section I of [A/CN.9/WG.I/WP.124](#)) for improved clarity. The revised Introduction includes a description of how providers of FinTech services, in particular FinTechs and BigTechs, operate, as suggested by the Working Group at its thirty-sixth session ([A/CN.9/1084](#), para 58) and also takes into consideration a concern of the Working Group that absence of appropriate infrastructure negatively affects the advantages of technological innovations applied to finance ([A/CN.9/1084](#), para. 59). Section B of the chapter presents selected examples of FinTech products that are particularly relevant for MSMEs. Section C discusses improvements to the current contract and commercial law framework applicable to FinTech providers. The paragraphs on data privacy and ownership, transparency and disclosure of information, dispute resolution and insolvency (paras. 189 to 192 of [A/CN.9/WG.I/WP.124](#)) have been removed since the provisions discussed thereof were mainly regulatory or they have been addressed in other Chapters of [A/CN.9/WG.I/WP.126](#) that deal with similar issues.

²⁵² GPFI, Promoting digital and innovative SME financing, 2020, p. 9.

²⁵³ The first mobile money solutions were offered at the end of the years 2000 and dealt with money transfer and payments with MNOs acting as agents of the more traditional financial institutions.

²⁵⁴ 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.

132. FinTech firms are mainly companies from the technology sector that specialise in the delivery of a particular financial product or service through the use of innovative technologies and business models.²⁵⁵ 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.²⁵⁶

133. 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 financial services they provide, their core non-financial activities, and the associated economies of scope and scale.²⁵⁷ For example, several BigTech firms active in electronic commerce have established credit lines for the MSMEs selling through the platforms (see paras. 144).

B. Examples of selected FinTech tools for access to credit

134. 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 in certain stages of the life cycle of the enterprises. For example, peer-to-peer lending and investment-based crowdfunding are particularly suitable for MSEs in their initial stages, while more experienced MSEs and medium-sized enterprises that aim to expand their markets can find access to credit through electronic commerce platforms a more profitable solution.

1. Peer-to-peer lending

135. Peer-to-peer lending is usually described as the provision of credit through online platforms that match borrowers with lenders. Loans obtained through the platforms are usually unsecured. Peer-to-peer lending platforms can range from platforms where an individual lender acts as direct lender for an individual loan to

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% 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/>.

²⁵⁵ 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% 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.

²⁵⁶ Finanzmarktaufsicht Österreich (FMA), Was ist FinTech?, retrieved from www.fma.gv.at/kontaktstelle-FinTech-sandbox/FinTechnavigator/was-ist-FinTech/.

²⁵⁷ BIS Annual Economic Report 2019, p. 61.

platforms where the lender can invest in pools or portfolios of loans indirectly.²⁵⁸ 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.

136. 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.²⁵⁹ Characteristics of peer-to peer lending 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 debt-based crowdfunding platforms.

137. Peer-to peer lending activities are 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 peer-to peer lending platforms in recent years²⁶⁰ has increased the need to ensure protection of users of the platforms, both lenders and borrowers, as several countries have experienced platform failures resulting in major financial losses for the users. Many of the risks relating to peer-to peer lending 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).

2. Investment-based crowdfunding

138. 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 business model which connects investors with MSMEs wishing to borrow money through issuing debt or equity to a crowd.²⁶¹ Crowdfunding has gained popularity among enterprises (including MSMEs) in many countries.^{262, 263} It comprises different kinds of activities, broadly organized in three categories (debt-based, equity-based and

²⁵⁸ See World Bank, Policy Research Paper on "Consumer Risks in FinTech – New Manifestations of Consumer Risks and Emerging Regulatory Approaches", 2021, p. 74.

²⁵⁹ Ibid. FinTech.

²⁶⁰ Ibid. According to the World Bank, in 2018, peer-to peer lending represented the largest online alternative finance model by market segmentation, facilitating 64 percent of the total global volume for the alternative finance industry.

²⁶¹ Ibid., p. 106.

²⁶² 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 20), p. 47.

²⁶³ The secretariat has deleted the reference to peer-to peer platforms in China as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 24).

non-investment).²⁶⁴ The term “investment-based crowdfunding” refers to debt-based and equity-based crowdfunding.²⁶⁵ Over time, crowdfunding has been increasingly managed by online platforms, which typically allow applications to be completed within a few hours.²⁶⁶

139. 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.²⁶⁷ Indeed, according to ITC, roughly two out of three crowdfunding campaigns failed to raise the target investment.²⁶⁸ 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.²⁶⁹

140. 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.²⁷⁰ 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.²⁷¹

141. 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.²⁷² 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.²⁷³ In order for MSMEs to attract funds and facilitate 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).²⁷⁴ Notably,

²⁶⁴ The non-investment category includes reward-based crowdfunding, whereby backers provide funding to individuals, projects or companies in exchange for non-monetary rewards or products, and donation-based crowdfunding, whereby donors provide funding to individuals, projects or companies based on philanthropic or civic motivations with no expectation of monetary or material return. See ITC, SME Competitiveness Outlook 2019 (supra, footnote 25), p. 72.

²⁶⁵ 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 20), p. 45.

²⁶⁶ World Economic Forum (supra, footnote 79), p. 13.

²⁶⁷ World Bank, Crowdfunding in Emerging Markets: Lessons from East African Start-ups, (2015), p. 3.

²⁶⁸ ITC, SME Competitiveness Outlook 2019 (supra, footnote 25), p. 78.

²⁶⁹ Ibid.

²⁷⁰ World Bank, Policy Research Paper on “Consumer Risks in FinTech” (supra, footnote 258), p. 107.

²⁷¹ For example, Australia, Brazil, the EU, Mexico, Nigeria, the US and Russia. Ibid., p. 107.

²⁷² European Commission report on “Inception impact assessment: Legislative proposal for an EU framework on crowd and peer to peer finance” (October 2017), p. 2.

²⁷³ Information for Development Program and World Bank, Crowdfunding’s Potential for the Developing World, 2013; UNDP, “Crowdfunding”, website, available at: www.sdfinance.undp.org/content/sdfinance/en/home/solutions/template-fiche12.html#mst-4.

²⁷⁴ 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

several domestic markets²⁷⁵ 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.²⁷⁶ 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.²⁷⁷

142. The use of Islamic FinTech (including crowdfunding) has gradually gained popularity in a number of jurisdictions.²⁷⁸ As discussed earlier (see para. 23 above), 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 financier purchases assets required by the client and then sells them to the client at a cost that includes a disclosed profit margin to be paid back, usually in instalments.²⁷⁹ This is also the model offered by most crowdfunding platforms in the market.²⁸⁰ 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.²⁸¹

3. Electronic commerce platforms

143. In its most basic definition, “electronic commerce” is generally understood as the buying and selling of goods and services over digital and electronic networks.²⁸² MSMEs can potentially enjoy several benefits from their participation in electronic commerce such as accessing markets outside their local area, increasing their customer base, minimizing their operational costs and enhancing their revenues.

144. As noted above, several BigTech firms operating electronic commerce platforms have established digital credit lines for the MSMEs selling their products through the platforms in order to finance them and help them sell more goods on the platform. Credits, which can be provided by the BigTech firm directly or by a regulated or non-regulated financial provider, are usually short-term, repayment and interests are typically automatically deducted from the MSME account on the platform and the MSME inventory stored in the BigTech’s warehouse serves as loan collateral. In addition, using data from the MSMEs’ transaction history on the platform and other records available through it, BigTech firms can easily assess MSMEs’ riskiness before providing any loan.²⁸³

145. Activities carried out on electronic commerce platforms are generally covered by existing laws and regulations governing electronic contracts and dispute resolution, as well as specific legal and regulatory measures for online platforms.

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.

²⁷⁵ For example, China and the Republic of Korea.

²⁷⁶ 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 20), pp. 46–47.

²⁷⁷ The secretariat has inserted this sentence as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 24).

²⁷⁸ Indonesia, the United States, United Arab Emirates, United Kingdom and Malaysia. See IBRD, *Leveraging Islamic FinTech to Improve Financial Inclusion* (2020), p. 27.

²⁷⁹ Islamic Development Bank, *The Road to the SDCs – The President’s Five-Year Programme: Progress and Achievements*, pp. 50–51.

²⁸⁰ For example, Ethis Group (Malaysia), Kapital Boost (Singapore) and Beehive (UAE).

²⁸¹ The secretariat has inserted this new paragraph to discuss the use of Islamic finance in the context of crowdfunding as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 62).

²⁸² World Bank, *Embedding Digital Finance in e-Commerce Platforms during the COVID-19 Pandemic*, 2020, p. 6.

²⁸³ The secretariat has inserted this new paragraph further to the Working Group’s deliberation at its thirty-sixth session (A/CN.9/1084, para. 58).

While it may be quicker and easier for MSMEs, in particular those lacking credit history, to access credit in this way than through financial institutions, there may also be risks associated with the use of such platforms and in the underlying business model.²⁸⁴ While certain risks may be similar to those of peer-to peer lending and investment crowdfunding models (e.g. the technological unreliability of the platform that may affect data protection), others are more specific to the electronic commerce platforms as a source of credit. For example, there may be risks arising from the timing information is disclosed (e.g. information on interest rates may be provided only after the transaction is concluded); the electronic commerce platform may use lending practices that encourage multiple borrowing (i.e., over-indebtedness) or employ abusive debt collection practices in case of the MSME default (e.g. if the MSME inventory is stored in the electronic commerce platform's warehouse and the electronic commerce platform can fulfil the MSMEs' orders, it can seize the inventory and sell it directly to repay the loan).

4. Other tools based on distributed ledger technology

146. Distributed ledger technology (“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). A distributed ledger system is thus the system (comprised of software and hardware components) that supports the deployment of those technologies and methods. Distributed ledger systems differ in their design, governance, purpose and use.

147. In recent years, FinTech firms have increasingly relied on the use of technologies (such as DLT) for securing rights and title and securing trade finance. For example, these companies have developed software especially designed for factoring, allowing applications to be processed online automatically and payment to be made instantly.²⁸⁵ 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.²⁸⁶ DLT-based models have also been developed for warehouse receipts systems and implemented in several industries such as agriculture and petrochemical industries.²⁸⁷

148. The potential of DLT has also been examined within the context of security rights registries. Due to the structure of security rights registries as centralized institutions (typically controlled by a governmental body or a central bank), permissioned (rather than permissionless) blockchain systems are considered as more appropriate platforms for security rights registries.²⁸⁸ The use of DLT (such as blockchain technology) could also be explored in order to ensuring data quality in

²⁸⁴ See World Bank, Policy Research Paper on “Consumer Risks in FinTech” (supra, footnote 258), p. 51.

²⁸⁵ World Economic Forum (supra, note 79), p. 20. For a definition of “FinTech” see [A/CN.9/WG.I/WP.119](#), para. 55.

²⁸⁶ 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.

²⁸⁷ 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.

²⁸⁸ While a permissioned system “enables the registry operator to determine which nodes can read the ledger and submit and validate registrations, thus ensuring the integrity of the data”, in a typical permissionless system “the persons responsible for a node are not generally known”. World Bank, Distributed Ledger Technology and Secured Transactions: Legal, Regulatory and Technology Perspectives – Guidance Notes Series, Note 1: Collateral Registry, Secured Transactions Law and Practice (May, 2020), p. 14.

credit reporting systems, given that DLT has several inherent features that align well with the requirements for security and integrity of stored data.²⁸⁹

149. It should be noted that reference to DLT in this section 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.

***Note to the Working Group:** The Working Group may wish to consider whether (i) there are any other commercial laws and regulations that govern the FinTech tools mentioned above; and (ii) there are any other FinTech tools relevant for MSME access to credit but not subject to any existing legal frameworks that provide certainty, clear allocation of risks for both financiers and MSMEs and are conducive for MSME access to credit.*

C. A legislative framework supportive of FinTechs tools for MSME access to credit

150. Most of the risks in using FinTech tools outlined in the paragraphs above are addressed through regulatory measures or laws other than commercial law. For example, inability 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. In keeping with the scope of the Future Text, the following paragraphs thus briefly discuss the importance of having in place domestic laws that enable transactions conducted through online platforms.

151. As noted by the IMF,²⁹⁰ an effective legal framework for FinTech products should include laws that ensure the formation, validity and enforcement of contracts concluded through technological means.²⁹¹ A preliminary step would be the adoption of laws that establish the functional and legal equivalence of electronic and paper-based documents, ensure the legal validity of electronic signatures and electronic records, address issues such as authentication, time and place of dispatch and receipt of electronic messages. In this respect, UNCITRAL legislative texts on electronic data transactions, digital identity and trust services can provide solutions appropriate to different legal traditions and States at different levels of economic development.

152. For example, the *UNCITRAL Model Law on Electronic Commerce (1996)*²⁹² (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. Specifically, article 11 of MLEC provides that an offer and acceptance may be expressed by means of electronic communications, and that a contract shall not be denied validity or enforceability on the sole ground that an electronic communication was used for that purpose. Articles 5 and 9 of MLEC also state that information shall not be denied legal effect, validity, enforceability or admissibility in evidence on the grounds that it is in the form of a data message. In addition, article 15 of MLEC specifically addresses time, place of dispatch and receipt of data messages. Under article 15, the

²⁸⁹ 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.

²⁹⁰ IMF Policy Paper, the Bali FinTech Agenda, 2018, p. 26.

²⁹¹ The secretariat has deleted the final part of this sentence (“such as... smart contracts”, para. 186 of [A/CN.9/WG.I/WP.124](#)), for improved clarity of the text.

²⁹² See UNCITRAL Model Law on Electronic Commerce with Guide to Enactment 1996, with additional article 5 bis as adopted in 1998.

location of information systems is irrelevant and a more objective criterion (i.e., the place of business of the parties) is adopted.

153. Moreover, article 7 of MLEC establishes a basic standard of authentication for data messages and sets forth criterion for the recognition of an electronic signature as functionally equivalent to a handwritten signature. The *UNCITRAL Model Law on Electronic Signatures (2001)*²⁹³ (MLES) adds certainty to the operation of the flexible criterion listed in article 7 through establishing criteria of technical reliability for the equivalence between electronic and hand-written signatures. In particular, articles 6 and 7 of MLES establishes a mechanism through which electronic signatures that meet objective criteria of technical reliability can be made to benefit from early determination as to their legal effectiveness. In the context of electronic records, the *UNCITRAL Model Law on Electronic Transferable Records (2017)*²⁹⁴ (MLETR) aims to enable the legal use of electronic transferable records both domestically and across borders. Specifically, article 10 of 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 Draft Provisions on the Use and Cross-border Recognition of Identity Management and Trust Services,²⁹⁵ which address various obstacles to the broader use of identity management and trust services, are expected to be finalized and adopted by UNCITRAL in 2022.

Note to the Working Group: *The Working Group may wish to consider whether to recommend the use of existing international standards concerning electronic commerce, electronic signature and electronic transferable records as discussed above.*

154. Use of technology such as smart contracts or robo-advisors, which are increasingly employed by the online platforms described above, might require additional legal clarity. Smart contracts, for which there is no unified definition, can be described as self-executing and immutable contracts. That is, 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.²⁹⁶ Their use may thus raise issues of validity, binding nature and enforceability. For example, States may need to determine whether the smart contract meets all specific requirements of a contract (e.g. offer and acceptance), including fairness and clarity standards, and whether the domestic law can encompass programming language as a valid language for a contract. Further, in case of court proceedings, States may wish to consider whether the nature of the automated contracts may result in the allocation of greater procedural risks (e.g. the “burden of proof”) and uncertainty on the weaker party of the contract (i.e. MSMEs). To clarify, in most countries, it is usually the claimant that has to prove the facts on which it seeks to rely and bear the risk in case they cannot be proven. In a contract automatically executed, as the claim may often concern the reversal of the contract performance, the performing party will thus have to prove that its performance was not due. Therefore, States may have to assess whether such allocation of the burden of proof is desirable for certain types of automated contracts, for example a loan repayment contract, where MSMEs do not have the resources to face such procedural risks. Laws could clarify that in those cases the automated contract should not shift the burden of proof on the weaker party or at least the MSMEs should not assume an excessive legal burden.

Note to the Working Group: *The Working Group may wish to consider formulating a recommendation to address the use of smart contracts as discussed above.*

²⁹³ See UNCITRAL Model Law on Electronic Signatures with Guide to Enactment (2001).

²⁹⁴ See UNCITRAL Model Law on Electronic Transferable Records (2017).

²⁹⁵ For a latest version of the Draft Provisions, see [A/CN.9/WG.IV/WP.170](#).

²⁹⁶ World Bank, Smart Contract Technology and Financial Inclusion, 2020, p. 6.

155. The use of robo-advisors, i.e. online platforms that use algorithms to automatically build and manage clients' portfolios, also carries legal implications such as the criteria the robo-advisors should fulfil, whether MSMEs can receive financial advice through them, the legal obligations of the robo-advisors (e.g. whether they owe fiduciary duties to the MSMEs, as in several countries investment advisers must avoid misleading their clients and act in good faith) or issues of liability for errors in which they may incur as well as available redress mechanisms for the MSMEs. Although these areas are still under development, both at the national and international level, certain States have revised their legal and regulatory frameworks to address some of those issues. For example, in one State a “*suitably-qualified person*” should test, review, and ensure the reasonableness of advice provided by the online advisor.^{297,298}

Note to the Working Group: The Working Group may wish to (i) consider formulating a recommendation to address the use of robo-advisors as discussed above, and (ii) identify other possible areas for future improvement to facilitate the use of FinTech tools for MSMEs to access credit.

VI. Additional measures to facilitate access to credit²⁹⁹

Note to the Working Group: The Working Group may wish to note that since this chapter of the Future Text focuses on policy and regulatory measures, no questions about possible inclusion of legislative recommendations have been included.

156. Needless to say, legislative measures alone are unlikely to achieve the goal of reducing MSMEs' constraints to access credit. Several policy and regulatory measures also play a significant role in facilitating access to credit for MSMEs, such as business registration, credit guarantee schemes, credit reporting, restructuring support, dispute resolution mechanisms, as well as transparency.

A. Business registration³⁰⁰

157. In order to create a sound business environment for the country's economy as a whole, it is generally in the interests of States and of MSMEs that such businesses operate in the formal economy. Entrepreneurs that have not yet commenced a business may be persuaded to do so in the formal economy if the requirements for formally starting their business are not considered overly burdensome, and if the advantages for doing so outweigh their interest in operating in the informal economy.³⁰¹ Such advantages often include visibility to the public, the market and, improved access to credit.³⁰²

158. Notably, 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

²⁹⁷ See Hong Kong, the Securities and Futures Commission (SFC) as referred to in <https://theFinTechtimes.com/robo-advisory-a-legal-perspective/>.

²⁹⁸ The secretariat has relocated the discussion on robo-advisors to a new paragraph (previously in para. 187 of A/CN.9/WG.I/WP.124) and provided additional examples for improved clarity of the text.

²⁹⁹ At its thirty-sixth session, the Working Group agreed that the headings of several sections in the draft Future Text could better reflect what the Future Text would advocate for (e.g. effective regimes, effective protection of weak parties etc.) (A/CN.9/1084, para. 36). In Chapter VI, the secretariat has not revised the title of each single section in full, but has grouped the sections under a self-explanatory “umbrella heading”.

³⁰⁰ The secretariat has added this new section on business registration as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 61).

³⁰¹ *UNCITRAL Legislative Guide on Key Principles of a Business Registry* (2019), para. 1.

³⁰² *Ibid.*, para. 21.

promote the formalization of MSMEs. It 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.³⁰³

159. 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.³⁰⁴ 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.³⁰⁵

160. The Business Registry Guide also suggests putting in place incentives for MSMEs and other businesses to comply with registration requirements. Such incentive will vary according to the specific economic, business and regulatory context, and may include promoting access to credit for registered businesses.³⁰⁶ 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 such benefits.

161. Last but not least, micro and small businesses owned by women are often over-represented in the informal economy. Finance gaps are likely to be greater for women-run MSMEs than for men-owned ones in most countries due to cultural biases or economic, social and legal constraints (see para. 6 above). In this respect, the Business Registry Guide specifically recommends that women should have equal and enforceable rights of access to the registration services of the business registry, and the requirements for business registration should not discriminate against potential registrants due to their genders.³⁰⁷ 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 determine the extent of informal barriers to establish a gender-neutral business registration framework.³⁰⁸

B. Credit Guarantee Schemes

162. In many States, in particular emerging economies or economies in transition, credit guarantee schemes (CGSs) represent a key policy tool to address the financing gap of MSEs that in most countries are the main beneficiaries of the CGSs (as opposed to medium-sized enterprises). CGSs 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 by the CGS in case of the MSE default. The payment of the defaulted loan entitles the CGS to claim the paid amount back from the MSE (see paras. 181 to 186).³⁰⁹

163. As additional benefits, CGSs may facilitate financial institutions overcome the problem of information asymmetry and reduce the low profitability of lending to

³⁰³ 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.

³⁰⁴ *Ibid.*, para. 155.

³⁰⁵ *Ibid.*, footnote 20 on page 63.

³⁰⁶ *Ibid.*, para. 23.

³⁰⁷ *Ibid.*, recommendation 34.

³⁰⁸ *Ibid.*, recommendation 34 and para. 175.

³⁰⁹ For improved coherence of the text, the secretariat has added to this paragraph a final sentence on the subrogation right of the Credit Guarantee Scheme (CGS) and has moved the discussion on additional benefits of CGSs to the next paragraph.

MSEs³¹⁰ 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, CGSs 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.³¹¹

164. OECD describes four major types of CGSs: (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 (iv) international schemes established by bilateral or multilateral government or IGO/NGO initiatives, which often combine a guarantee fund with technical assistance programmes.³¹²

1. Public Credit Guarantee Schemes

165. Public CGSs are one of the main public support mechanisms to facilitate MSEs' access to credit. Other mechanisms with a similar scope include direct lending programs, facilities for the pledging of MSE loans as collateral against refinancing from central banks, tax and interest rate subsidies.³¹³ 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 CGSs have proven to be a particularly effective countercyclical tool to address the negative consequences of the credit market failure resulting from those crisis or events.³¹⁴

166. Neither public CGSs 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.³¹⁵ Public CGSs 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 CGS 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 CGSs.³¹⁶ For this reason, it is important that public CGS and other public support mechanisms are limited in time for as long as needed to transition to a market-based lending system and should be implemented mainly to correct the underlying problems of the domestic financial system and facilitate access to credit in a more productive way.³¹⁷

³¹⁰ OECD, Discussion Paper on Credit Guarantee Schemes, 2010 p. 4.

³¹¹ *Ibid.*, pp. 4–5.

³¹² *Ibid.*, pp. 7–8.

³¹³ See 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.

³¹⁴ *Ibid.*, pp. 374–427.

³¹⁵ *Ibid.*, p. 416.

³¹⁶ The secretariat has added the discussion on the positive and negative aspects of CGSs in keeping with deliberations of the Working Group at its thirty-sixth session (A/CN.9/1084, para. 41).

³¹⁷ The World Bank and FIRST Initiative, 2015, Principles for Public Credit Guarantee Schemes for SMEs, p. 120.

(a) Criteria for effective public credit guarantee schemes**(i) Foundations of Public CGSs³¹⁸**

167. In order to ensure efficient and proper use of public resources, it is important to establish ex ante the CGSs' objectives and performance criteria, regularly evaluate their performance³¹⁹ as well as 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 where CGSs can operate, the design and operation of efficient CGSs rely on a mix of legislative and regulatory measures that should at least 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 CGSs.

168. Public CGSs should be established on the basis of appropriate and specific legislation that clearly defines all aspects of the scheme. The World Bank and FIRST Initiative *Principles for Public Credit Guarantee Schemes for SMEs*, prepared in 2015,³²⁰ indicate that such legal or 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, the State's liability with respect to the provision of the service should be addressed in the applicable laws.

169. Public CGS 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 CGS; (iii) general terms and conditions that apply to the government investment; (iv) the relationship between the State as shareholder and the CGS's board and management; and (v) the CGS's funding sources. If the State chooses to establish the CGS in partnership with the private sector, the responsibilities and obligations of both parties should be clearly defined and the rights of the minority shareholders should be protected so as to promote their active participation in the governance and decision-making processes of CGSs.³²¹

170. Further, the mandate of CGSs should specify the MSE sector(s) targeted by a CGS and its main line(s) of business and it should be broad enough to accommodate cyclical developments in the targeted sector(s). In order to assess its continuing validity over time, it would be important to establish mechanisms for its periodic review. In addition to the provision of credit guarantees, the mandate may include other services, such as provision of information, technical assistance, training and counselling.³²² In order to ensure the managerial autonomy and accountability of the CGSs in implementing the mandate, it is advisable to separate the government oversight from the day-to-day operations of the CGSs.³²³ The legal or regulatory framework should also establish that the CGS has sufficient funds to implement the

³¹⁸ For improved clarity, the secretariat has shortened and revised this sub-section as follows: (i) the title of the sub-section has been adjusted; (ii) para. 113 of A/CN.9/WG.I/WP.124 has been deleted and a generic reference to the need of an enabling legal environment has been included in this paragraph (that is largely based on para. 114 of A/CN.9/WG.I/WP.124); (iii) the discussions on the managerial autonomy and on funds allocation and on partnerships with the private sector (paras. 118 and 119 of A/CN.9/WG.I/WP.124) have been merged with paras. 170 and 169, respectively; (iv) a new paragraph (para. 171) on the budget implications of public CGSs has been added, consistent with the deliberations of the Working Group at its thirty-sixth session on the risks of improper use of taxpayers money to fund CGSs (A/CN.9/1084, para.41).

³¹⁹ 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.

³²⁰ 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 Future Text focus on those aspects of the Principles that are relevant for its scope.

³²¹ The World Bank and FIRST Initiative (supra, footnote 317), p. 14.

³²² Ibid., p. 15.

³²³ Ibid., p. 12.

mandate and specify the responsibility of the State with regard to the provision of the initial capital and additional subsidies during the life of the CGS.³²⁴

171. As contingent liabilities, public CGS can expose the State to significant budget risks resulting in unanticipated cash outflows and increased debt. It is thus important that the State carries out a long-term assessment of their budgetary implications before establishing a CGS. A thorough fiscal risk assessment should consider the factors that are likely to affect the overall financial balance of the CGS as well as the options for risk allocation between the parties (i.e., CGS, lending financial institutions and borrowers) involved in the CGS.

(ii) *Eligibility criteria*³²⁵

172. Efficient CGSs should 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 would also allow the State to avoid an improper use of the public funds invested in the operation of the CGS.³²⁶ 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,³²⁷ or a minimum operation time.³²⁸ 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.³²⁹ States should have the possibility to broaden the eligibility criteria of the businesses benefitting from the CGS in case of major financial crisis or other emergencies that have an impact on the domestic economy.^{330,331}

173. Consistent with the applicable legal and regulatory framework, CGSs could establish programmes dedicated to subclasses of firms³³² 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, CGSs may create a list of ineligible MSMEs (on the basis of their credit profile and repayment

³²⁴ Ibid., p. 13.

³²⁵ The secretariat has added additional examples of eligibility criteria for MSEs in the footnotes in line with the deliberations of the Working Group at its thirty-sixth session (A/CN.9/1084, para. 41).

³²⁶ The secretariat has added this sentence ("transparency and clarity... of the CGS") to further highlight the importance of eligibility criteria in protecting misuse of public funds, as deliberated by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 41).

³²⁷ The World Bank and FIRST Initiative (supra, footnote 317), p. 18.

³²⁸ See for instance the Malaysian BizSME scheme that requires a minimum time in operation often ranging from 1-5 years.

³²⁹ 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 CGS 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.

³³⁰ For example, during the COVID-19 pandemic, many States 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.

³³¹ The secretariat has deleted the reference to COVID-19 pandemic measures from the final part of the paragraph (see para. 120 of A/CN.9/WG.I/WP.124) and moved it to a footnote (see footnote 330) in keeping with deliberations of the Working Group at its thirty-sixth session that discussion on emergency measures in the text should not just be limited to COVID-19 related measures (A/CN.9/1084, para 13).

³³² Some CGSs 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).

reputation, for example)³³³ or may explicitly exclude some subsectors from its scope of operations.³³⁴

174. Eligibility criteria for lending financial institutions should also be clearly defined, possibly on the basis of objective indicators such as their capacity in serving small businesses and their risk management capabilities.^{335,336} Typically,³³⁷ eligible financial institutions include, but are not limited to, commercial banks development banks, licensed credit institutions or supervised non-bank financial service providers,³³⁸ credit cooperatives,³³⁹ or not-for-profit entities with the primary purpose of supporting small businesses' development.³⁴⁰ To address the need for quick provision of liquidity during major natural disasters or financial crisis, States should have the possibility to include other categories of eligible financial institutions.^{341,342}

175. Further, the legal or regulatory framework should clarify which types of loans are eligible for coverage.³⁴³ 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.³⁴⁴

³³³ 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.

³³⁴ For example, in Lithuania support is not granted to firms operating in gambling, ammunition, tobacco and alcohol production and sales.

³³⁵ The World Bank and FIRST Initiative (supra, footnote 317), p. 18.

³³⁶ 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).

³³⁷ The secretariat has improved this sentence for further clarity of the text.

³³⁸ For example in the Philippines.

³³⁹ For example in Brazil.

³⁴⁰ For example in Egypt, where the SEB program is implemented through contracting NGOs.

³⁴¹ 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 330), 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 CGSs, 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.

³⁴² The secretariat has deleted the reference to COVID-19 pandemic related measures from this paragraph (para. 122 of A/CN.9/WG.I/WP.124), moved them to a footnote (see footnote 341) and revised the paragraph accordingly further to deliberations of the Working Group at its thirty-sixth session (A/CN.9/1084, para 13).

³⁴³ CGSs usually extend guarantees through two modalities: the individual method and the portfolio method. In the individual method, guarantees are provided on a loan-by-loan basis and the CGS assesses all loan applications and selects those to guarantee; there is thus a direct relationship between the MSE and the CGS. In the portfolio method, the criteria of the portfolio are previously negotiated by the lending financial institutions and the CGS, and the lending financial institutions can then attach the guarantee to the loan without consulting the CGS. There is thus no direct relationship between the CGS and the MSE. The World Bank and First Initiative Principles note that a portfolio approach may be useful for the promotion of certain types of small businesses – for example, start-ups or women-owned businesses, regardless of the specific project presented. A World Bank study in 2008 found that only 14 per cent of the 76 schemes studied used a portfolio model; 9 per cent of schemes used a combination of the loan-level/individual model and portfolio model (see T. Beck, L. Klapper, J.C. Mendoza, The Typology of Partial Credit Guarantee Funds around the World, The World Bank Development Research Group, November 2008).

³⁴⁴ The World Bank and FIRST Initiative (supra, footnote 317), pp. 18–19.

(iii) Mitigating the risks of public CGSs

176. As noted above, public CGS 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, it is thus important that decisions to establish public CGS follow a process that ensures that policy makers understand the risks associated with the CGS. This could range from informing the parliament about the type and implications of the CGS and how they could affect the public budget to receive parliament approval on the CGS establishment. In addition, when designing the CGS, 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 CGS. 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 CGS.^{345,346} 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.

177. 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 that is guaranteed by the CGS. As it has been noted, a high coverage ratio can be very attractive to lending financial institutions, since they would be protected from credit risk and they may not have an incentive to engage in proper monitoring activities, leading to excessive risk-taking and thus endangering the schemes' sustainability.³⁴⁷ On the contrary, if the CGS bears only a small share of the risk, financial institutions might disregard the programme.³⁴⁸ Policy needs would usually drive the decision of the State on the coverage ratio.³⁴⁹ The coverage ratio should be clearly indicated in the contractual agreements between the CGS and the financial institutions and the agreements should also clarify how the losses are shared between the CGS and the financial institutions.

178. Since the allocation of risks between the CGS 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. In particular, it should 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.³⁵⁰

179. 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 institutions 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

³⁴⁵ 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 341), p. 3.

³⁴⁶ For improved consistency of the text, the secretariat has moved reference of capping individual loans to this paragraph (para. 124 of [A/CN.9/WG.I/WP.124](#)) and the examples of flexibility measures during the COVID-19 pandemic in footnote 345.

³⁴⁷ IMF, Special Series on COVID-19 (supra, footnote 330), p. 2.

³⁴⁸ 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.

³⁴⁹ The secretariat has deleted the example of COVID-19 pandemic related measure from this sentence, in keeping with deliberations of the Working Group at its thirty-sixth session that the discussion on emergency measures in the text should not just be limited to the COVID-19 pandemic. See also supra, footnotes 342 and 346.

³⁵⁰ IMF, Special Series on COVID-19 (supra, footnote 330), p. 4.

repayment. However, excessive collateral requirements can defeat the purpose of the guarantee and the CGS 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.³⁵¹

(iv) *Fees*

180. The guarantee's fee is usually established in the legal or regulatory framework of the CGS rather than on a case-by-case basis, usually by having a fixed flat fee or a variable one. When determining the fees, a balance should be struck between the goals of the guarantee's programme and its financial sustainability. Fees, along with the income that the CGS may derive from its investment activities and any government subventions, should cover the cost of the operations and the expected cost of credit risk. The pricing policy should be transparent and CGSs should be able to adjust it on the basis of their credit loss history and market developments,³⁵² as well as on the country's specific circumstances. For example, in response to major crisis affecting their overall economic structures, certain States set caps on the amounts of fees that can be charged or prohibited the charging of fees.³⁵³

(v) *MSE default and loan loss recovery*

181. The legal or regulatory framework and the contractual arrangements should clarify the precise circumstances that prompt the CGS's intervention, for example the opening of insolvency proceedings against the MSEs or the MSE's late repayment of the loan.³⁵⁴

182. As the IMF notes, in some States³⁵⁵ the guarantees issued by CGSs are considered independent guarantees, where the guarantor's obligation is not linked to the underlying debt (see para. 93). In others, the CGS has a subsidiary liability³⁵⁶ (see para. 95) whereby the enforcement or validity of the guarantee is dependent on that of the principal debtor, but a provisional payment by the CGS 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.³⁵⁷ 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.³⁵⁸

183. Guarantee payment procedures should be settled in a clear and transparent way to avoid costly disputes between the financial institutions and the CGS. Contractual agreements between the CGS and the financial institution should clearly state 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. A common practice is to specify a minimum mandatory waiting period before a claim can be made to a CGS 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.³⁵⁹ In addition, it is advisable that the agreements require a detailed written explanation if the claim is refused.³⁶⁰

³⁵¹ The World Bank and FIRST Initiative (supra, footnote 317), p. 20.

³⁵² Ibid., p. 21.

³⁵³ For example, the crisis generated by the COVID-19 pandemic. With this regard see IMF, Special Series on COVID-19 (supra, footnote 330), p. 3.

³⁵⁴ 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.

³⁵⁵ For example, Italy and the United States.

³⁵⁶ For example, France and the Netherlands.

³⁵⁷ IMF, Special Series on COVID-19 (supra, footnote 330), p. 5.

³⁵⁸ The World Bank and FIRST Initiative (supra, footnote 317), p. 22.

³⁵⁹ Ibid.

³⁶⁰ Ibid.

184. Finally, the legal and regulatory framework should clarify the CGS's rights once it has paid the guarantee.³⁶¹ 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 CGS (statutory subrogation). 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 CGS 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 that the domestic legal framework recognizes the subrogation of the public CGS as legally enforceable. To reinforce their subrogation rights, certain CGS may conclude a separate agreement with the MSE under which this latter agrees to indemnify the CGS in respect of any payment made.

185. A public CGS 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 CGSs 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.³⁶²

186. If the CGS provides only partial guarantees, both the CGS 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 CGS or both are responsible for debt recovery from the MSE. To maximize the results, it may be convenient for the CGS to entrust the financial institutions 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,³⁶³ for example, the lending financial institution is required to act as the agent of the CGS during the enforcement stage.³⁶⁴

2. Private Guarantee Schemes³⁶⁵

187. As noted above (see para. 164), 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 States, corporate guarantee schemes are considered as specialized financial institutions and their prudential regulation is aligned with that of the banks.³⁶⁶

188. MGSs are usually established by independent MSEs or their representative associations for the purpose of providing guarantees only to their members.³⁶⁷ 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.³⁶⁸ Although they are

³⁶¹ Ibid.

³⁶² See <https://blogs.worldbank.org/psd/protection-reallocation-public-credit-guarantee-schemes-post-pandemic-world>.

³⁶³ For example, Chile. See IMF, Special Series on COVID-19 (supra, footnote 330), p. 5.

³⁶⁴ Ibid.

³⁶⁵ In keeping with the deliberations of the Working Group at its thirty-sixth session (A/CN.9/1048, para. 43), the secretariat has added this sub-section on private guarantee schemes to enhance the scope of the text.

³⁶⁶ GIZ, SMEs' Credit Guarantee Schemes in Developing and Emerging Economies, 2014, p. 22.

³⁶⁷ Ibid., p. 15.

³⁶⁸ 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.

largely funded from membership fees, in certain countries mutual guarantee schemes operate with some form of State support.³⁶⁹

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

190. 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.³⁷⁰

3. International Schemes for Credit Guarantees³⁷¹

191. International assistance to set up and operate CGSs 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,³⁷² the Asian Development Bank,³⁷³ the African Development Bank), have thus launched international CGSs 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 UNDP³⁷⁴ and the United Nations Capital Development Fund (UNCDF) are engaged in the promotion of international guarantee schemes either in cooperation with national governments or with development banks. There are also privately funded CGSs 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.

192. International CGSs are usually established in conjunction with technical assistance packages in order to facilitate their design and implementation.³⁷⁵ They can have different goals, such as support the development of MSEs in general³⁷⁶ or of

³⁶⁹ OECD, *Credit Guarantee Schemes* (supra, footnote 310), pp. 8–9.

³⁷⁰ L. Cusmano, *SME and Entrepreneurship Financing*, pp. 67–68 (supra, footnote 368).

³⁷¹ The secretariat has added this subsection on international credit guarantee schemes as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 42).

³⁷² See www.worldbank.org/en/topic/sme/finance.

³⁷³ See for example “ADB to Provide Local Currency Lending to Support MSMEs Growth in Kazakhstan | Asian Development Bank”.

³⁷⁴ 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.

³⁷⁵ A. Green (2003), *Credit Guarantee Schemes for Small Enterprises - An Effective Instrument to Private Sector-led Growth*, p. 19.

³⁷⁶ 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.

specific groups of entrepreneurs (e.g. women, youth, minority groups etc) or of MSEs working in specific sectors (e.g. digital or rural).³⁷⁷

C. Credit reporting³⁷⁸

193. As noted above (see para. 17), information asymmetry is one of the most significant challenges for MSEs (although medium-sized enterprises may face this obstacle too), and for financiers. Credit reporting systems, where they are in place, play a key role in addressing this problem as they enable the collection and distribution of financial information on potential borrowers thus allowing financiers to learn more about the MSE characteristics, past behaviour, repayment history and current debt exposure. This can reduce the cost for financiers to conduct due diligence and result in lower interest rates for MSEs.³⁷⁹ Credit reporting, however, may be less relevant in assessing the creditworthiness of the MSE in the context of relationship lending where interactions between the financier 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.³⁸⁰

194. Credit reporting providers can be either public entities or privately owned companies: the latter tend to cater to the information requirements of financiers, while the data collected and provided by the former are geared towards use by policymakers, regulators, and other public authorities and entities.³⁸¹ 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).³⁸²

195. The International Committee on Credit Reporting (ICCR) has noted the absence in many States 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 concerning payment and financial performance than is required for individual consumers.³⁸³ 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.³⁸⁴

196. 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.³⁸⁵ This section provides a

³⁷⁷ 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.

³⁷⁸ The secretariat has shortened this section to better highlight those aspects of the discussion more consistent with the scope of the Future Text. For improved coherence, the discussion on dispute resolution (paras. 151 and 152 of A/CN.9/WG.I/WP.124) has been merged with the section on Procedures and mechanisms for resolving disputes on access to credit.

³⁷⁹ 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.

³⁸⁰ The secretariat has: (i) revised the opening paragraph of the section (para. 133 of A/CN.9/WG.I/WP.124) for further improvement; and (ii) added reference to credit reporting in the context of transaction-based lending and relationship lending as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 46).

³⁸¹ The secretariat has replaced the terms "credit registry" and "credit bureau" with terms clearly indicating their public or private nature (A/CN.9/1084, para. 45) as requested by the Working Group at its thirty-sixth session. See also *supra*, footnote 23.

³⁸² World Bank, *General Principles for Credit Reporting*, 2011, p. 7.

³⁸³ *Ibid.*, p. 13.

³⁸⁴ World Bank, ICCR, *Facilitating SME financing* (*supra*, footnote 44), p. 20.

³⁸⁵ *Ibid.*

general introduction to those aspects. 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.³⁸⁶

1. Criteria for effective credit reporting systems

(a) Reporting obligations

197. There seem to be no standard requirements across States for MSEs to submit financial information to public agencies and other entities. In many States 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 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.³⁸⁷ 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.³⁸⁸

198. In order to facilitate financial reporting by MSEs, it would thus be important that States adopt a legal framework that addresses transparency requirements and specifies which type of business information and data required from MSEs should be considered confidential and not subject to 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. Furthermore, the legal framework should balance the right of MSEs to protect their know-how with that of their creditors to collect, analyse and distribute credit-related data.^{389,390}

(b) Integrating available information with public agencies' records

199. The most common sources of data in the case of commercial credit reporting are banks and other regulated financial institutions. It should be noted that 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.³⁹¹ Other potential sources of data and information can include commercial entities such as factory 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.³⁹²

³⁸⁶ See 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.

³⁸⁷ The secretariat has added this sentence further to a suggestion of the Working Group at its thirty-sixth session (A/CN.9/1084, para, 47).

³⁸⁸ World Bank, ICCR, *Facilitating SME financing* (supra, footnote 44), p. 20.

³⁸⁹ *Ibid.*, p. 21.

³⁹⁰ The secretariat has revised this paragraph (para. 138 in A/CN.9/WG.I/WP.124) for improved clarity.

³⁹¹ 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 others may refuse to share information because of bank secrecy obligations. See World Bank, ICCR, *Facilitating SME financing* (supra, footnote 44), p. 18.

³⁹² 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.*

200. In order to offset the scarce or inadequate information from all those sources, credit reporting providers (whether public or private) could rely on information from the public sector which may include, among others, official identification data for MSEs, data that contribute to determining the MSE's behaviour (e.g. bankruptcy information from the courts) and financial information.³⁹³ However, accessing that information may be difficult due to legal and practical issues. First, not all States may have laws or regulations that facilitate access to the information maintained by public agencies. Moreover, in some cases, some or all of the data maintained by the public agency may be considered confidential and access might be restricted.³⁹⁴ 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. It would thus be advisable for States to improve their domestic laws in order to permit and facilitate the use of information held by public authorities.

201. In addition to an inadequate legal or regulatory framework, practical impediments may also affect the collection of data. 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.³⁹⁵ As it may not be feasible for many States to adequately support all public agencies that collect data relevant for credit reporting purposes, resources could be prioritized to first assist those agencies (e.g. tax authorities) whose records are key to evaluate the MSE's creditworthiness.

(c) Data quality

202. 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.³⁹⁶ Inaccurate data can result in unjustified loan denials, higher borrowing costs, and other unwanted consequences for MSEs, data providers (e.g. banks and financial institutions) and credit reporting providers. The accuracy of data depends on how they are gathered, usually through loans and contracts (see para. 199), 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 financiers.³⁹⁷

203. In order to ensure the high quality of the data, it would be advisable that the legal and regulatory framework specify the purposes for which data may be collected, the circumstances in which they can be used, the required quality and accuracy, the timeliness³⁹⁸ 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.³⁹⁹ These requirements should be applicable to both data and credit reporting providers.

204. It would be equally important that States ensure the accuracy and reliability of the information provided by the MSEs when interacting with the data providers (e.g. banks, financial institutions, commercial companies). 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.⁴⁰⁰

³⁹³ *Ibid.*, p. 19.

³⁹⁴ *Ibid.*

³⁹⁵ *Ibid.*, p. 21.

³⁹⁶ See General Principle 1 in World Bank, *General Principles* (supra, footnote 382), p. 25.

³⁹⁷ *Ibid.* (supra, footnote 382), p. 26.

³⁹⁸ OECD, *Discussion Paper on Credit Information Sharing*, p. 12.

³⁹⁹ World Bank, *General Principles* (supra, footnote 382), p. 37.

⁴⁰⁰ OECD, *Discussion Paper on Credit Information Sharing* (supra, footnote 398), p. 12.

(d) Alternative data⁴⁰¹

205. 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, make e-payments, conclude an online transaction with their bank or manage their receivables, payables, and record-keeping online, they create digital footprints.⁴⁰² In recent years, such footprints, defined as alternative data,⁴⁰³ have gained increased relevance in credit reporting.⁴⁰⁴ This trend can facilitate access to credit, especially for those small businesses operating in the informal economy that have no or “very thin credit files”.⁴⁰⁵ Alternative data can also prove beneficial for financiers⁴⁰⁶ 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 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.⁴⁰⁷ 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 financiers.⁴⁰⁸

206. To support an effective and transparent use of alternative data, the legal and regulatory framework should clarify how they may be obtained and processed in a way that preserve their accuracy and integrity; ensure their compliance with credit laws or regulations, and avoid potential discrimination. For example, social media data are often collected without the MSE’s consent which may result in their unlawful use since those data are usually not meant to be used for credit reporting purposes. In addition, if their collection is not carefully monitored, alternative data may lead to discriminatory scoring practices based on the race, colour, sex, marital status or other similar grounds of the MSE’s owner.⁴⁰⁹

207. Given the movement of alternative data across borders, issues of how data are treated in different States may easily arise. There may be differences in the specific data that the credit reporting providers can collect and in the data that can be shared cross-border, or difficulty in identifying MSEs in different countries due to inconsistent or non-standardized identification systems. For example, international experts fora recommend that States, in cooperation with relevant international bodies,

⁴⁰¹ In keeping with deliberations of the Working Group at its thirty-sixth session (para. 48, [A/CN.9/1084](#)), the secretariat has revised this sub-section to address the positive and negative implications of the use of alternative data in a more balanced way.

⁴⁰² OECD, Discussion Paper on Credit Information Sharing (supra, footnote 398), p. 12.

⁴⁰³ 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.

⁴⁰⁴ 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/> and www.forbes.com/sites/samanthasharf/2018/02/13/forbes-FinTech-50-2018-the-future-of-lending/?sh=361ffa5a1329. 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.

⁴⁰⁵ GPFI, Use of Alternative Data (supra, footnote 403), p. 5.

⁴⁰⁶ See for example www.datappeal.io/5-benefits-of-alternative-data-for-banks-and-financial-institutions-from-enriched-credit-scoring-to-lead-qualification/

⁴⁰⁷ GPFI, Use of Alternative Data (supra, footnote 403), p. 5.

⁴⁰⁸ See Hong Kong Monetary Authority, Alternative Credit Scoring of Micro-, Small and Medium-sized Enterprises, p. 29.

⁴⁰⁹ GPFI, Use of Alternative Data (supra, footnote 403), p. 6.

could harmonize different aspects of their legal regimes applicable to cross-border data flow.⁴¹⁰ In particular, the adoption of a global unique identifier for MSEs (and medium-sized enterprises) would greatly facilitate cross-border data-sharing.⁴¹¹

(e) Access to credit reporting services

208. Since they serve different beneficiaries (see para. 194 above), public and private credit reporting providers may have different rules regarding access to their services.⁴¹² However, as noted by the World Bank, the legal and regulatory framework supporting credit reporting should ensure 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).⁴¹³ 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.⁴¹⁴

D. Restructuring support for MSMEs in financial distress

209. 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.⁴¹⁵ According to some studies, the costs of financial distress represent 10 per cent to 20 per cent of the market value of the firm.⁴¹⁶ 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, financiers 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*⁴¹⁷

210. 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*").⁴¹⁸ 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

⁴¹⁰ Ibid., p. 26.

⁴¹¹ Ibid.

⁴¹² The secretariat has revised the opening of this paragraph (para. 150 of [A/CN.9/WG.I/WP.124](#)) in keeping with deliberations of the Working Group at its thirty-sixth session ([A/CN.9/1084](#), para. 49).

⁴¹³ GPFI, *Use of Alternative Data* (supra, footnote 403), p. 42.

⁴¹⁴ Ibid., p. 35.

⁴¹⁵ The secretariat has inserted this sentence to promote the use of technology as a means of reducing costs in insolvency proceedings as requested by the Working Group at its thirty-sixth session ([A/CN.9/1084](#), para. 55).

⁴¹⁶ A. Gurrea-Martinez, *Implementing an Insolvency Framework for Micro and Small Firms*, 2020, footnote 49.

⁴¹⁷ The secretariat has expanded the discussion on informal restructuring and new financing as requested by the Working Group at its thirty-sixth session ([A/CN.9/1084](#), para. 54).

⁴¹⁸ *Official Records of the General Assembly, Seventy-sixth Session, Supplement No. 17 (A/76/17)*, Annex II.

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.⁴¹⁹

211. 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).⁴²⁰ They are also encouraged to identify and remove 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).⁴²¹ 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.⁴²²

212. 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.⁴²³ 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. 243). 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.⁴²⁴

E. Procedures and mechanisms for resolving disputes on access to credit⁴²⁵

213. The existence of an effective dispute resolution system is critical in determining the decision of MSMEs 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.⁴²⁶ 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.

214. In many countries settling financial disputes in court may not be a viable option for most MSEs since this may be too complex and usually more expensive than the loan value and MSEs 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

⁴¹⁹ Ibid., Recommendation 107.

⁴²⁰ Ibid., Recommendation 105 and related commentary as contained in [A/CN.9/WG.V/WP.174](#), paras. 408–410.

⁴²¹ Ibid., Recommendation 104 and related commentary as contained in [A/CN.9/WG.V/WP.174](#), para. 406.

⁴²² Ibid., Recommendation 106 and related commentary as contained in [A/CN.9/WG.V/WP.174](#), paras. 411–414.

⁴²³ Ibid., Recommendation 103.

⁴²⁴ Ibid., Recommendation 103 and related commentary as contained in [A/CN.9/WG.V/WP.174](#), paras. 399–403.

⁴²⁵ The secretariat has revised the title for improved clarity.

⁴²⁶ CGAP, *Financial Access*, 2010, p. 32.

effectively and at low cost, may thus encourage MSEs 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 MSEs *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 MSE's default, given the low amount of the credit usually granted to the MSE. The length of dispute resolution often affects the cost of lending for the financial institutions and their disposition to lend since fast 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 MSEs. As CGAP has noted, availability of redress mechanisms for financial disputes thus is not just a matter of fairness to address the power imbalance between MSEs and financial service providers, but it is beneficial to the credit industry overall as it enhances its sustainability.⁴²⁷

1. Criteria for effective dispute resolution procedures and mechanisms

215. 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 mechanisms should be accessible at a reasonable cost, independent, fair, accountable, timely and efficient and should not impose burdens on the users.⁴²⁸ This is not only important when the domestic judicial system is too expensive for MSEs, but also when it is too burdensome or cannot operate in a timely manner, which negatively affects both MSEs and financial service providers.⁴²⁹ 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. 217).

(a) Internal complaint handling procedures

216. 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.⁴³⁰ 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.⁴³¹

⁴²⁷ *Ibid.*, p. 31.

⁴²⁸ OECD, G20 High Level Principles on Financial Consumer protection (2011), p. 7.

⁴²⁹ *Ibid.*, p. 51.

⁴³⁰ *Ibid.*, pp. 49–50.

⁴³¹ *Ibid.*

(b) External redress mechanisms

217. 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. In several countries ad hoc banking mediation services exist, which can either offer specific services for MSEs, ranging from providing information to assisting in the negotiations with financial institutions,⁴³² or be open to businesses of all sizes, including MSEs, and legal status.^{433,434} All the mechanisms described in this paragraph are not mutually exclusive and in some countries more than one mechanism can address clients' complaints.⁴³⁵

218. It should be noted that in most States ombudsman⁴³⁶ and other similar offices⁴³⁷ 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.⁴³⁸ In order to determine the eligibility of a business to access those services, States often 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. In one country,⁴³⁹ however, an ombudsman programme for MSMEs was established, among others, to handle complaints against those financial institutions designated by the government to support those businesses on the basis of various government programmes and projects.

219. The World Bank notes that such mechanisms can be established by industry or associations or by law.⁴⁴⁰ 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.⁴⁴¹

220. An important aspect of these mechanisms is whether they can render binding decisions as some of them may rely more on voluntary compliance although reputational risks may often pressure the financial entities to comply. For example, in one country if a financial institution does not comply with the decisions of the relevant redress mechanism a notice of non-fulfilment is made public.⁴⁴² To ensure MSE protection, it would be important that the decisions of the external redress mechanism

⁴³² See for example the *service de médiation crédit bancaire* in Belgium. Further information available at:

www.ejustice.just.fgov.be/cgi_loi/change_lg_2.pl?language=fr&nm=2013003461&la=F.

⁴³³ For example in France, where a banking mediation service operates under the supervision of the National Bank. See <https://mediateur-credit.banque-france.fr/>.

⁴³⁴ The secretariat has added the examples of the banking mediation services further to the request of the Working Group at its thirty-sixth session to include more examples of national redress mechanisms in this section (A/CN.9/1084, para. 57).

⁴³⁵ CGAP, Financial Access (supra, footnote 426), p. 31.

⁴³⁶ 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.

⁴³⁷ See for example 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.

⁴³⁸ The secretariat has revised the opening sentences of this paragraph (para. 171 of A/CN.9/WG.I/WP.124) for improved clarity of the text.

⁴³⁹ See Republic of Korea.

⁴⁴⁰ 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 for Financial Consumer Protection, 2017, p. 52. 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.

⁴⁴¹ Ibid., p. 51.

⁴⁴² 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”.

are binding on financial entities⁴⁴³ 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 MSEs will be highly disadvantaged.⁴⁴⁴ 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.⁴⁴⁵

221. 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.⁴⁴⁶ 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.⁴⁴⁷ 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.

222. 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

223. 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.⁴⁴⁸ 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.⁴⁴⁹

(d) Effectiveness

224. 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

⁴⁴³ 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.

⁴⁴⁴ World Bank, Good Practices (supra, footnote 440), p. 52.

⁴⁴⁵ 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.

⁴⁴⁶ Network of Financial Services Ombudsman Schemes, Effective approaches to fundamental principles, 2014, p. 2.

⁴⁴⁷ 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 ADR scheme (e.g. Armenia, Australia, Canada, Trinidad and Tobago and the United Kingdom). See World Bank, Good Practices (supra, footnote 440), p. 52.

⁴⁴⁸ Ibid.

⁴⁴⁹ For example, Australia, Armenia and Malta.

mechanism and the mechanism's decisions should be taken and made available within a specified time.

(e) Fairness

225. 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

226. 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.

2. Resolving disputes between MSMEs and providers of FinTech products⁴⁵⁰

227. 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.⁴⁵¹ Moreover, not all countries may have external redress mechanisms where it is possible to lodge a complaint against FinTech providers⁴⁵² and, as noted above (see para. 214), settling financial disputes in court may not be a viable option for micro and small enterprises in many countries.

228. In order to provide some protection to MSME users of FinTech services, in some countries⁴⁵³ 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.⁴⁵⁴ 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.⁴⁵⁵ It has been suggested that online dispute resolution mechanisms may be an efficient and effective option to resolve disputes on FinTech products.⁴⁵⁶ They are easy-to-use,

⁴⁵⁰ The secretariat has revised these paragraphs (paras. 190 and 191 of A/CN.9/WG.I/WP.124) for improved clarity and moved them here for consistency of the text.

⁴⁵¹ ASBFEO, www.asbfeo.gov.au/sites/default/files/documents/ASBFEO-FinTech-borrowing-guide.pdf.

⁴⁵² 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 258), p. 78. As noted at page 13, the publication focuses on retail consumers a category that also includes MSMEs.

⁴⁵³ For example, Kenya and Indonesia. See, World Bank, *Consumer Risks in FinTech* (supra, footnote 258), p. 68.

⁴⁵⁴ Ibid.

⁴⁵⁵ See OECD, *Effective Approaches for Financial Consumer Protection in the Digital Age: FCP Principles 1, 2, 3, 4, 6 and 9*, 2019, p. 45.

⁴⁵⁶ 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*

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, like several FinTech services are. They require, however, a conducive legal environment that permits, for example, choice of forum and does not require physical appearance of the parties or physical written submission of documents. States may thus have to amend domestic laws accordingly. The *UNCITRAL Technical Notes on Online Dispute Resolution* (2017) may provide guidance to States, ODR platforms and administrators regarding how to develop and use such mechanisms.

F. Transparency⁴⁵⁷

229. Generally speaking, a transparent and fair market makes it easier for customers (including MSMEs) to find the most suitable products in terms of quality and costs, and to make informed choices. Recognizing the importance of transparency for MSME's access to credit, G20 and OECD adopted, in 2015, a number of high-level principles on SME (small and medium-sized enterprises) financing and Principle 6 focused on "Improve transparency in SME finance markets".⁴⁵⁸ It was elaborated that information asymmetries in finance markets should be minimised to increase market transparency, encourage greater investor participation and reduce financing costs for SMEs. Information infrastructures for credit risk assessment should aim to support an accurate evaluation of the risk in SME financing. To the extent possible and appropriate, credit risk information should be standardised and made accessible to relevant market participants and policy makers to foster both debt and non-debt SME financing instruments. Accessibility of this information at the international level should be supported to foster SMEs' cross-border activities and participation in global value chains.⁴⁵⁹

230. 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). The issues of transparency and disclosure of information to MSMEs are of great importance given that in certain States 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.⁴⁶⁰ A sound legal framework would 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.⁴⁶¹ 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.

231. 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 through techniques such as "flat" interest and complex fee structures.⁴⁶² 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

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⁴⁵⁷ The secretariat has added this new section on transparency as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 60).

⁴⁵⁸ G20/OECD High-Level Principles on SME Financing, 2015, p. 6.

⁴⁵⁹ *Ibid.*, p. 6.

⁴⁶⁰ GPFI, Promoting digital and innovative SME financing (*supra*, footnote 252), p. 72.

⁴⁶¹ *Ibid.*, p. 84.

⁴⁶² A/CN.9/780, para. 37.

advice.⁴⁶³ Among other things, microfinance institutions should be required to adopt standard pricing formulas (with appropriate disclosure standards) as well as standard repayment schedules.⁴⁶⁴

232. In general, transparency in MSME finance markets could be improved through implementation of various registry systems, such as the business registry, the credit registry and collateral registry. Digitalization of the business registry has been cited as one effective tool to enhance its accessibility, thereby improving transparency.⁴⁶⁵ While the degree of digitalization may vary, it is recommended in the *UNCITRAL Legislative Guide on Key Principles of a Business Registry* that submission of applications for the registration of a business, requests for amendment of the registered information of a business, and searches of the business registry may be done remotely through electronic means.⁴⁶⁶ In order to facilitate access to information, it is also recommended that the creation of unnecessary barriers should be avoided, such as requirements for the installation of specific software; charging expensive access fees; or requiring users of information services to register or otherwise provide information on their identity.⁴⁶⁷ Issues concerning the security rights registry (in the context of movable assets) and the credit registry have been discussed above (see Chapter III, Section H.1 (a)(ii) on key features of an efficient registry system and Chapter VI, Section C on credit reporting).

G. Safeguards against unfair practices

233. The paragraphs above note the importance of transparent contract terms and fair customer practices to facilitate access to credit. As “repeat players” and in order to reduce transaction costs, financiers tend to use standard term contracts for financial transactions with counterparts (including MSMEs).⁴⁶⁸ Negotiation and any resulting variation of the standard term contracts would result in an increase in the transaction costs that financiers may not consider economical when the requested loan amount is relatively small (e.g. in the context of MSME financing). Personalisation of contracts may also result in higher borrowing costs for MSMEs.^{469,470} 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.^{471,472}

234. Given the limited financial literacy of many MSEs, they may not be able to identify or fully understand the potential detrimental contractual conditions,⁴⁷³ especially when the clauses are in small print and in technical language. As a result, they may suffer from certain financiers who abuse of their stronger bargaining position. The risk of such abuse is particularly high in the context of FinTech products

⁴⁶³ Ibid., para. 40.

⁴⁶⁴ Ibid.

⁴⁶⁵ OECD and G20, *Effective Approaches for Implementing the G20/OECD High-Level Principles on SME Financing*, 2018, p. 29.

⁴⁶⁶ *Business Registry Guide*, recommendations 37 and 38.

⁴⁶⁷ Ibid., recommendation 39.

⁴⁶⁸ 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 financiers.

⁴⁶⁹ L. Gullifer, I. Tirado, *A global tug of war: a topography of micro-business financing*, 2017, pp. 12–13.

⁴⁷⁰ The secretariat has eliminated direct and indirect reference to the greater bargaining power of the financiers and clarified the effects of contracts’ personalisation in this paragraph (para. 154 of [A/CN.9/WG.I/WP.124](#)) in order to address Working Groups’ comments at its thirty-sixth session ([A/CN.9/1084](#), para. 52) that this section of the working paper should be more balanced.

⁴⁷¹ 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/>.

⁴⁷² The secretariat has revised the opening sentence of this paragraph (para. 153 of [A/CN.9/WG.I/WP.124](#)) to provide a more balanced approach as requested by the Working Group at its thirty-sixth session ([A/CN.9/1084](#), para. 52).

⁴⁷³ World Bank Good Practices for Financial Consumer Protection (supra, footnote 440), p. 34.

and services,⁴⁷⁴ given the speed with which contracts are concluded electronically, often without prior or sufficient review of their terms and conditions.⁴⁷⁵

235. In order to tackle unfair contract practices, some countries have extended to MSEs contract law rules that protect weaker individuals negotiating contracts with parties who enjoy a stronger bargaining position, including financial transactions. For example, in one country⁴⁷⁶ the regime on unfair contract terms provisions has been extended to cover small business contracts in the financial service sector.⁴⁷⁷ The legislation specifies what a small business is and clarifies the parameters according to which a contract term can be deemed unfair. This occurs 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.⁴⁷⁸ Examples of unfair terms and conditions may include high default interest rates, unfair termination clauses or disadvantageous definitions of events of default.⁴⁷⁹

236. A law that follows international best practices, would, for instance, prohibit unfair term or condition in standard financial contracts and, if used, such terms or conditions would be considered void and legally unenforceable.⁴⁸⁰ Another sanction 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 MSE.⁴⁸¹ 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.⁴⁸² In specifying types of clauses that the law declares unfair and therefore invalid or not effective, legislators and policy makers may wish to consider the possible impact that an overly restrictive approach might have on the availability of credit.

237. Fair treatment of MSEs would also require that in the process of contract formation the financier explains the different types of credit suitable to the MSE and their implications for the business,⁴⁸³ 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 financiers. To facilitate comparison, States may require that the information is disclosed in a prescribed form that may include standardized methods of displaying charges. In addition, States may require that financiers allow for a reflection period before the conclusion of the contract or a period for exercising a right of withdrawal after the conclusion of the contract or a combination of the two to ensure that the small business has fully understood the contract terms and assessed the consequences of their application. States might also protect small businesses by establishing legislative caps on certain rates and charges imposed in the contract: for example, certain States have established caps on default rate clauses.⁴⁸⁴ In case the MSE's credit

⁴⁷⁴ 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>.

⁴⁷⁵ Ibid.

⁴⁷⁶ I.e. Australia, see *supra*, footnote 471.

⁴⁷⁷ The secretariat has revised the first part of this paragraph (para. 156 of A/CN.9/WG.I/WP.124) to delete reference to individual consumers as suggested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 51).

⁴⁷⁸ Australian Security and Investment Commission (*supra*, footnote 471), p. 8.

⁴⁷⁹ A/CN.9/913, para. 42.

⁴⁸⁰ World Bank, Good Practices (*supra*, footnote 440), p. 34.

⁴⁸¹ Ibid., p. 34.

⁴⁸² L. Gullifer, I. Tirado, A global tug of war, p. 14.

⁴⁸³ For example Belgium, see *Loi relative à diverses dispositions concernant le financement des petites et moyennes entreprises*, 21 Décembre 2013, available at: www.ejustice.just.fgov.be/cgi_loi/change_lg_2.pl?language=fr&nm=2013003461&la=F.

⁴⁸⁴ For example, Germany and Spain, *ibid.*, pp. 14–15.

application is rejected, States may require financiers to provide the reasons for rejection in a clear and understandable way.⁴⁸⁵

238. In addition to fair contract terms, an appropriate legal and regulatory framework would also provide consequences for relationships between the financiers 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.⁴⁸⁶ Another good practice would be for States to set a minimum threshold to identify whether a practice is unfair or not.⁴⁸⁷ With regard to credit products, financiers 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, financiers 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.⁴⁸⁸

239. Defining unfair practice standards might be influenced by domestic social and cultural norms, for example in certain countries requiring women entrepreneurs to have a spousal consent to obtain a loan might be considered an acceptable practice.⁴⁸⁹ Be that as it may, the law should address 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.

240. Finally, as it has been noted, when adopting rules on unfair contractual terms and practices, lawmakers should attempt to achieve a balance between the measures protecting MSEs and those that motivate financiers to lend (see also para. 18 above). 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 financiers 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.^{490,491}

H. Measures to tackle low financial literacy of MSEs

241. 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 interest over their assets. 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.

⁴⁸⁵ For example, Belgium. See *supra*, footnote 483.

⁴⁸⁶ For example the United Kingdom and Malaysia as cited in World Bank, *Good Practices* (*supra*, footnote 440) p. 35.

⁴⁸⁷ *Ibid.*, p. 36.

⁴⁸⁸ *Ibid.*

⁴⁸⁹ *Ibid.*

⁴⁹⁰ L. Gullifer, I. Tirado, *A global tug of war* (*supra*, footnote 482), p. 1.

⁴⁹¹ The secretariat has slightly revised this paragraph (para. 161 of [A/CN.9/WG.I/WP.124](#)) for improved clarity and to ensure a more balanced approach to the needs of financiers and MSEs (see also *supra*, footnote 470).

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 programs 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.⁴⁹² Financial education initiatives may thus be complemented by programs⁴⁹³ aiming at strengthening the managerial and technical skills of MSEs.⁴⁹⁴

242. Another important aspect of the process is developing the capacity of financiers so that they become attuned to the financial needs of MSEs. They need to know which types of financial products to offer and how to address the difficulties that MSEs face in approaching financiers, preparing necessary documentation, and meeting relevant criteria. They 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 financiers 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.⁴⁹⁵

1. Capacity-building for MSEs

243. In several States national 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, microenterprises are often the most targeted segment within the MSMEs' group. Certain countries pursue MSEs' financial education as part of broader national strategies aiming at promoting financial inclusion⁴⁹⁶ or increasing formal sector employment.⁴⁹⁷

244. Effective national strategies may be provided through different channels such as formal education in schools or universities or ad hoc government programmes.⁴⁹⁸ The strategies usually cover general elements of financial literacy as well as topics relevant to building the MSE capacity to interact with financiers, such as knowing who to approach for assistance on financial matters; recognizing the interplay of personal and business finances; awareness of financing opportunities, financial risks and 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

⁴⁹² OECD and G20, *Effective Approaches for Implementing the G20/OECD High-Level Principles on SME Financing*, 2018, pp. 30-31.

⁴⁹³ For example, Italy provides financial support to those MSMEs that are using consulting services to improve production processes and management and organizational structures.

⁴⁹⁴ The secretariat has added the discussion on improving the management skills of MSEs as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 65).

⁴⁹⁵ The secretariat has addressed the importance of capacity building for regulators as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 65).

⁴⁹⁶ A. Atkinson (OECD), *Financial Education for MSMEs and Potential Entrepreneurs*, 2017, p. 31.

⁴⁹⁷ *Ibid.*, p. 33.

⁴⁹⁸ 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.

adequate monitoring and evaluation of strategy implementation are in place and that the strategies are independent from a country's political cycles.⁴⁹⁹

245. In addition to the national strategies, other initiatives coordinated by industry organizations and trade unions, the financial sector or NGOs may be implemented at the local and national level.⁵⁰⁰ For example, in one country the stock exchange industry has launched a programme to help small and medium-sized enterprises deal with access to long-term financing opportunities. In particular, the programme provides training and tutorship to the managers of those businesses so that they can improve their skills and networking capacity in order to facilitate a future possible listing in the public equity market.⁵⁰¹

246. Depending on the nature of the financial education initiatives, and in order to reach the widest group of beneficiary 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 States, on line platforms have been set up to facilitate exchanges and mutual learning between small businesses.⁵⁰² Other States, 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 national strategies and the initiatives coordinated by the private sector often benefit from tools and programmes⁵⁰³ developed by international organizations or networks⁵⁰⁴ that reflect global best practices.

2. Capacity-building for financiers⁵⁰⁵

247. As noted above (see para. 242), it is important to improve the capacity of financiers 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 financiers and MSMEs by facilitating their direct interaction through awareness campaigns, brokerage and match-

⁴⁹⁹ The secretariat has added a new final sentence in the paragraph (para. 196 of [A/CN.9/WG.I/WP.124](#)) for improvement of the text.

⁵⁰⁰ A. Atkinson (OECD), *Financial education* (supra, footnote 496), pp. 34–35.

⁵⁰¹ See the ELITE programme launched by the London Stock Exchange Group. See www.aimlisting.co.uk/lse-elite-programme/.

⁵⁰² See Chile and Singapore, respectively as cited in A. Atkinson, 2017, *Financial Education for MSMEs and Potential Entrepreneurs*. 52 and 58.

⁵⁰³ 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.

⁵⁰⁴ 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 entrepreneurship (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.

⁵⁰⁵ The secretariat has revised this section for further improvement as requested by the Working Group at its thirty-sixth session ([A/CN.9/1084](#), para. 64).

making.^{506,507} More generally, financiers 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.⁵⁰⁸ Capacity building initiatives for financiers may be organized under the aegis of central regulators⁵⁰⁹ or the relevant government authorities⁵¹⁰ 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.⁵¹¹

248. As in the case of financial literacy for MSEs, international organizations⁵¹² are also active in offering support to improve financiers' capacity to serve MSEs through technical assistance activities⁵¹³ 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.

3. Capacity-building for regulators⁵¹⁴

249. 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. When new financial products (e.g. digital financial services) are developed, regulators should be able to identify their key risks and opportunities and translate them into clear regulatory standards. Similarly, in countries where MSEs access credit through informal funding mechanisms (e.g. the mobile bankers – see para. 36 above), regulators should be able to understand the scope and rules of such

⁵⁰⁶ See OECD, Discussion Paper, SME Ministerial Conference, 22–23 February 2018 (supra, footnote 13 p. 19). The secretariat has added this sentence to address a request of the Working Group at its thirty-sixth session (A/CN.9/1084, para 65 (a)).

⁵⁰⁷ 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 financiers and MSEs (A/CN.9/1084, para. 65).

⁵⁰⁸ IFC/World Bank, *Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises*, p. 17.

⁵⁰⁹ 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.

⁵¹⁰ For example, in Zambia the National Financial Inclusion Strategy 2017–2022 among others aims to build the capacity of financiers to lend to MSMEs, in particular farmers. See www.boz.zm/National-Financial-Inclusion-Strategy-2017-2022.pdf.

⁵¹¹ See the Alliance for Financial Inclusion, *Financial Education for the MSMEs: Identifying MSME Educational Needs*, 2020, p. 7.

⁵¹² 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.

⁵¹³ 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.

⁵¹⁴ The secretariat has added this section, which also includes reference to the awareness of informal mechanisms to access credit, as requested by the Working Group at its thirty-sixth session (A/CN.9/1084, para. 65).

mechanisms and formulate legal and regulatory regimes that recognize their use and preserve their main features.

250. 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 fora, 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.

251. 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 fora 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. 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 networks⁵¹⁵ 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 regulators⁵¹⁶ and partner with States and regional entities to offer technical assistance and advisory programmes tailored to the needs of a specific country or region.

⁵¹⁵ 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.

⁵¹⁶ 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.