Trust Through Transparency

APPLICABILITY OF CONSUMER PROTECTION SELF-REGULATION TO MICROFINANCE

Right to Choose
Right to Information
Right to Safety
Right to Be Heard

- Consumer Bill of Rights

Patrick McAllister
The Small Enterprise Education and Promotion Network

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Consumer Protection Task Force

March 2003

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Printed in the United States of America

Cover design: Dan Benderly

Graphic layout: Linda Wolfe Keister

Printing: Copy General

ACKNOWLEDGMENTS

This technical note is the result of a year-long collaboration among members of The Small Enterprise Education and Promotion (SEEP) Network Consumer Protection Task Force. As with other SEEP projects, the development of this technical note has been a truly collaborative effort. Neither the task force nor this technical note would exist without Deb Burand, Foundation for International Community Assistance (FINCA) International, who initiated the task force with her enthusiastic belief that consumer protection is as important as prudential regulation. I would also like to thank all the members of the task force who contributed their time and expertise to the paper, particularly Ximena Arteaga, FINCA International, and Beth Porter, Freedom from Hunger, who helped keep me on track when I needed it. Ximena also contributed the case examples of consumer issues in microfinance. Brad Sabel, a partner at Shearman & Sterling, germinated the concept within the task force of thinking about consumer protection in terms of a code, and Dana de Kanter, The SEEP Network, provided critical input to enable the task force to organize and produce this technical note.

Special thanks to Tom Kennedy, U.S. Agency for International Development (USAID), Bureau for Humanitarian Response (BHR), Office of Private and Voluntary Cooperation (PVC); Xavier Reille, Consultative Group to Assist the Poorest; and Elisabeth Rhyne, ACCION, who provided useful comments on an earlier draft.

The opinions expressed in this guide are those of the individual members of the task force and not their respective organizations.

Finally, we gratefully acknowledge USAID/BHR/PVC, whose financial support of SEEP's working group activities provided the resources for the task force to meet and produce this technical note.

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INTRODUCTION

A good deal has been written about the potential harm of microfinance to consumers: low interest rates lead to non-price rationing, high interest rates impose an unfair burden on the poor, and hidden costs take advantage of unsuspecting consumers. One way for microfinance institutions (MFIs) to counter this criticism is through a self-regulatory process ensuring more transparent disclosure of practices that may be harmful. Self-regulation is only one element of consumer protection, but it is the one element over which MFIs have the most direct control.

Throughout its history, microfinance has been a largely unregulated industry. A few high profile examples of MFIs harming consumers have resulted in increasing government interest in regulatory oversight for consumer protection. In the interest of protecting consumers, governments have introduced interest rate caps or limits on loan sizes. Those protective measures, however, ultimately make credit more expensive and limit the field of microfinance.

This technical note examines how nonprudential self-regulation has helped other industries, especially the financial services industry in the United States, win the trust of consumers and avoid heavy-handed and costly regulation. The technical note begins by providing the background of the consumer movement and the response of business to consumer issues. The review of other industries focuses particularly on the United States because of the availability of materials, with some reference to the international consumer movement and some examples from other countries. Both the consumer perspective and the business perspective are described to emphasize their fundamental difference in approach to consumer protection: the former operates through government regulation, the latter through industry-sponsored self-regulation.

Self-regulation is accomplished through establishing, distributing, and enforcing codes of practice to which businesses agree to adhere. Although many different types of codes are used by business (codes of ethics and codes of conduct, for example), codes of practice are the basis of self-regulation because they are specific, making adherence verifiable.

When businesses overcome the obstacles of credibility and cost to successfully self-regulate, their transparency is rewarded with a trust dividend. Consumers are more likely to use the services of a business they trust, and governments are more likely to permit self-regulation of an industry they trust. Microfinance provides a compelling case for self-regulation, similar to the rationale for the high degree of self-regulation in the mainstream financial service industry, albeit with less threat of external regulation. The paper concludes by arguing that MFIs should embrace self-regulation to protect consumer rights, both because this approach is morally correct and because it is in the industry's business interest to do so.

For practitioners interested in developing a code of practice for consumer protection, Box 2 provides an overview of the template and discussion guide that the SEEP Consumer Protection Task Force developed and published separately in this series.[1]

Perspectives on Consumers

The customer is the immediate jewel of our souls. Him we flatter, him we feast, compliment, vote for, and will not contradict. —Ralph Waldo Emerson

Emerson was not a businessman.

An inherent tension exists between consumers and the businesses that serve them. Neither can exist without the other, yet their objectives are fundamentally different. The business is concerned with profit, while the consumer is concerned with getting the products or services needed for the least cost. The consumer is not concerned about the businesses' profits, except to the extent that the desired products and services continue to be available in the market. Likewise, the businessman is unconcerned about the consumer's satisfaction except to the extent that it impacts the bottom line. With each pursuing its proper interests, however, both can gain.

It is important to consider this tension as we look at the role of a microfinance institution and the microfinance industry in safeguarding the rights of consumers. That role is different from, but complementary to, the role of consumer rights advocates or government regulators. MFIs are unique among businesses in embracing both strong business and strong social objectives. This well-documented duality, which runs through most microfinance institutions, should make it easy for MFIs to embrace self-regulation for consumer rights because it supports both objectives.

The Consumerism Perspective

Interest in consumer rights began, and continues, as a counterweight to caveat emptor, the doctrine that the buyer, or consumer, is at risk when purchasing goods or services. The seller cannot be held liable under this doctrine for selling shoddy goods. Beginning in 1890, urbanization driven by factory work in America's cities led to urban poverty, hazardous working conditions, child labor and a variety of consumer problems. Socially conscious citizens

[1] SEEP members established the task force in October 2001 to promote transparency between MFIs and their customers. Because of its practitioner focus, the task force decided to begin its work by providing MFIs with a tool to help them reap the benefits of transparency. In the process, SEEP learned a lot about transparency and consumer protection. This technical note is an attempt to synthesize and disseminate that information to its members and the wider microfinance community. The complete template and discussion guide are available from The SEEP Network (www.seepnetwork.org).

formed groups to address these problems, and the consumer movement in America was born. (See Garman 2002 for a history of consumer issues.)

From its inception, the movement sought to whittle away at caveat emptor by making business liable for the quality of its products, beginning with the infamous issue of food adulteration. The primary method for increasing business liability was through legislation. Between the years of 1890 and 1920, the United States Congress passed more than 50 consumer protection laws, and in 1938 Congress amended the Federal Trade Commission (FTC) Act, giving the FTC the authority to investigate unfair practices. The role of government as consumer watchdog was official and the die was cast, creating a division between consumers and business that continues, more or less, to this day.

Consumer rights took on a new vigor (and a new name—consumerism) in 1962 when President John F. Kennedy addressed the U.S. Congress on the subject of consumer issues and established the Consumer Bill of Rights: the right to choose, the right to safety, the right to be informed, and the right to be heard.

Government interest and activism in consumer issues have continued to grow in the United States and around the world. Consumer interests are identical everywhere and consumers on every continent have fought for more protection; Consumers International represents consumer advocate groups in more than 100 countries. In 1985, the United Nations issued guidance on consumer protection, essentially echoing Kennedy's Consumer Bill of Rights. Today in the United States, caveat emptor seems anachronistic with the high degree of protection afforded consumers through regulatory oversight and legal recourse. In developing countries, however, the battle is still being fought.

Consumerism has provided many benefits to consumers, but in battling caveat emptor, consumers and their advocates have set themselves against business. It is important to keep this in mind when thinking about the business perspective on consumers.

The Business Perspective

Business in the United States took a reactive approach to consumerism until the 1960s, primarily by lobbying against pro-consumer legislation. The business lobby has been and continues to be successful in gutting some consumer protection bills. In 1978, a coalition of business leaders known as The Business Roundtable (TBR) was instrumental in defeating establishment of an independent consumer protection agency within the U.S. government.

In the 1960s, however, television was changing America. When a group of women in Denver, Colorado, picketed their local grocery store to protest high prices, television broadcast the images to the entire country. No longer would incidents of consumer outrage be limited to a call to the store manager or a card in the suggestion box. Some businesses took note that not all publicity is good publicity and began co-opting consumerism as a low-cost way to improve their image, and perhaps sales, by hiring "consumer affairs professionals." The recognition that business could no longer ignore its customers made headlines when Giant Food hired Esther Peterson away from President Lyndon B. Johnson's administration. Peterson had been the special assistant to the president for consumer affairs and hers was the first appointment of a high-level consumer affairs executive at a major U.S. company. Access by consumer-minded professionals to executives at the highest level played an important role in improving business response to consumer concerns.

Today most businesses take consumer issues seriously and have adopted a proactive strategy. Rather than react to consumer legislation, business leaders now fight to set and enforce their own standards to protect consumers. The main arguments for self-regulation over government regulation are the cost to the business of compliance, the cost to the taxpayers of a regulatory mechanism, and the tendency for regulation to be so narrow as to discourage innovation (Laware 1990). Often, impending government regulation is the catalyst for an industry to establish a self-regulatory mechanism, but not always. As consumers have become comfortable exercising their rights in the United States, businesses have learned to anticipate consumer needs.

The United States today is a largely self-regulated market. The government actually regulates only a small fraction of the codes and standards to which industry must comply. Self-regulation is both an acknowledgment of the high cost of compliance with government regulation, and recognition that transparency is necessary to convince consumers that their needs are being met. Each industry and trade association has codified, published, and enforces the practices for which it holds itself accountable. This transparent process enables consumers to know exactly what to expect. From flammability standards for upholstered fabric that covers any piece of furniture sold in the United States, to the accuracy of advertisements for that furniture, standards, created and enforced by the industries and trades themselves, are available to any consumer. Many businesses have chosen to create and publicize standards higher than those required by law or industry, in an effort to convince consumers of their high quality, environmental friendliness, or safety, thereby gaining a competitive edge.

Thus, the business perspective on consumers has changed over time. From ignoring consumer demands, to grudgingly obeying laws that protect consumers, businesses now prefer to be accountable to consumers through a transparent process of self-regulation. This process enables consumers to exercise their rights, without the high cost of government regulation.

Self-Regulation

> *Regulate: 1. To control or direct according to a rule. 2. To adjust in conformity to a specification or requirement. —American Heritage Dictionary*

Self-regulation may be applied by the individual enterprise, the trade association, or the business association. The first type of self-regulation is the individual enterprise that holds itself accountable for certain standards or practices. Infractions are handled internally, although another party (such as a government regulator) may monitor compliance with internal regulations. Visa's Issuer Privacy Principles are frequently cited as a model of this level self-regulation.[2]

The second type is the trade association, in which representatives from individual enterprises establish and agree to be bound by a common set of standards or practices; they agree to be held accountable by the association for any infractions. The Irish Bankers' Federation (IBF) regulates all banks operating in Ireland, in a wide range of practices, including customer relations.

The third type is the business association, in which member businesses from different industries voluntarily abide by regulations as a condition of membership. The Better Business Bureau is perhaps the best example of this type of self-regulation.

Both government and industry generally prefer self-regulation to government regulation because of its lower cost structure and ability to allow innovation. Especially where new technologies are being developed, smart regulators will take a cautious approach to regulation, allowing the market to improve services and drive down cost. Regulators rely on self-regulation by the industry in question to reduce the perceived risk in the industry (Vartanian 1998, p. 241). When the U.S. government became concerned with the way banks were treating consumer information, four banking industry trade groups persuaded Congress to reduce proposed restrictive regulation by adopting their own privacy guidelines (House Committee on Banking 1997).

Codes

Self-regulatory mechanisms are generally grouped into three general categories: codes of ethics, codes of conduct, and codes of practice, although the boundaries among them are blurred. The following sections present the different types of codes that the financial services industry uses. Unfortunately, accepted definitions for each type of code do not exist. For example, the Canadian Bankers Association has a code of conduct that would better fit under this publication's definition of a code of practice because it was established by the industry and defines procedures. The semantic differences, however, are less important than the different purpose of each type of code in self-regulation.

Codes of Ethics

Also called codes of professional conduct, codes of ethics are the most general of the codes used by business. Codes of ethics originally sought to document the unwritten gentleman's "code of honor" that previously governed human relations, and some professional oaths (such as the Hippocratic Oath), which were general expressions of character and duty. Thomas Percival wrote the first code of professional ethics in 1803 in response to questionable practices that

[2] For many years, the U.S. banking industry has been actively pursuing self-regulation by individual banks to safeguard consumer privacy. In 1995, Visa established its ten principles as a model for its affiliated credit card issuers (mainly banks) to develop their own privacy policies. Because these issuers are monitored for compliance with other consumer protection regulations, regulators have sanctioned banks for noncompliance with internal regulations (Schrader 1998).

were creeping into the medical profession at the end of the eighteenth century. Percival justified this first code for the medical profession for two reasons that resonate in our own industry today. The first was to affirm the profession's core collective responsibility to care for the sick; the second, to create accountability for cost-conscious trustees who would sometimes overcrowd hospital wards and prescribe inferior-quality drugs (Baker, Fall 1999, p. 3). In other words, the reasons were self-regulation and consumer rights. Percival wanted to assert the responsibility of the professionals to self-regulate, and to avoid counter-productive, short-term, cost-saving measures at the expense of the customer.

Today, codes of ethics are present in most large companies and in professional and trade organizations. They may be short, as illustrated by the Institute of Chartered Financial Analysts' four-point code shown in Box 1. Or they may be long, as found in the International Association of Financial Planners' five-page code, divided into canons, rules, and guidelines (IAFP 1982).

Box 1. Institute of Chartered Financial Analysts' Code of Ethics

A Chartered Financial Analyst should:

1. Conduct himself with integrity and dignity and encourage such conduct by others in the profession.
2. Conduct himself and encourage the practice of financial analysis in a manner that would reflect credit on himself and on the profession.
3. Act with competence and strive to maintain and improve his competence and that of others in the profession.
4. Use proper care and exercise independent professional judgment.

Whatever the length or style, most codes of ethics tend to be general expressions of the philosophical underpinnings of the organization. Many codes of ethics continue the tradition of describing the comportment of the professional or tradesperson, a modern day professional oath.

Codes of Conduct

Compared to codes of ethics, which are philosophical in nature, codes of conduct are practical (note the difference from codes of *professional* conduct, which are synonymous with codes of ethics). Where codes of ethics serve as a reminder of the larger obligations of the professional or staff member, codes of conduct set out clearly what is permissible and what is not. They are the rules of the game.

Codes of conduct are frequently used to advise employees how the institution expects them, as individuals, to act. For example, the Richmond Federal Reserve Bank Code of Conduct covers such issues as alcohol and drug use, use of bank property, and use of position for private gain. It lets the employee know what is expected, and what to expect in case of a violation.

Whereas a code of ethics is internally focused ("This is how *we* should act"), a code of conduct is generally externally focused ("This is how *you* should act") and includes a description of the repercussions of not respecting the code.

Some so-called codes of conduct are merely suggestive, with no obligation or enforcement, and would not be used for self-regulation.

Codes of Practice

Codes of practice put the philosophy expressed in a code of ethics into practice. They are practical and specific, focusing on one area of operations such as customer relations or subprime lending. Whereas codes of ethics are general enough to promote discussion about how one can best live up to it, codes of practice are specific enough to be verifiable, and thus, are at the heart of most self-regulation.

Consumer-related codes of practice generally reflect the Consumer Bill of Rights. The United Nations Guidelines on Consumer Protection, however, go well beyond what is generally found in codes of practice (UNCTAD 2001).

The name associated with a type of code (ethics, practice, or conduct) will vary by industry and location. Codes of practice relating to consumer protection are often referred to as codes of conduct. It is not the intent of this technical note to suggest a preference for nomenclature. Where a code is specific and verifiable, however, it is categorized here as a code of practice.

Consumer Education

Because of the complicated nature of financial services, businesses offering these services often undertake consumer education campaigns as part of the self-regulatory effort. Such campaigns enhance the overall positive effect of self-regulation in two ways: first, the consumer is better able to interpret and use the protections afforded him or her, such as how to file a complaint; second, the business or industry is recognized by consumer advocates to be fulfilling a social obligation, and is therefore considered a good citizen.

A consumer education campaign may be implemented by the business or trade organization directly, or through collaboration with another social service agency. In the United States, for example, the American Bankers Association creates programs and products that member banks can use to educate consumers about financial products and help consumers manage their own finances. Large banks often develop their own consumer education services (see, for example, American Bankers Association [ABA] and Bank of America). Banks also work with local social service agencies to ensure consumers understand their rights and responsibilities. The consumer education campaign is an important element for ensuring the successful implementation of a consumer protection code of practice.

Trust Through Transparency

Emerson was not a businessman, but he was not dumb. He and generations of businesspeople have realized that the best way to win customers and keep them is to gain their trust. The simplest way, and that which has served generations of honest businesspeople and shysters alike, is to build personal relationships with customers. Vendors build trust by transparently displaying their goods. If a customer thinks the merchandise shoddy, she will simply tell the proprietor; a smart business owner will probably do something about it to retain a valued customer.

Service industries, where there is no physical product to display, have traditionally built their customers' trust on character and relationships: the banker is a rich man—he can be trusted with your savings. But what happens when the business gets too big or complicated to let every customer see what goes on behind the scenes? What happens when customers do not know who is running the bank? The business can still win the customer's trust by establishing codes of practice that transparently disclose what goes on, how it results in a high-quality product or service, and how the business will handle complaints.

For many companies the decision to adopt a code of practice for consumer protection is an easy one. Many have a strong customer orientation that is already articulated in a code of ethics or mission statement because of a foundational belief that treating the customer well is the right thing for a business to do. A code of practice helps customers and employees understand how to put this belief, generally articulated by the founder or leader of a company, into practice.

When a business adopts a code of practice, it has determined that a benefit is to be derived from the transparency of its internal processes, what this publication calls the "trust dividend."

Costs and Benefits

The business decision to adopt a code of practice is based on a standard cost/benefit analysis. Expected benefits should outweigh the cost of establishing and enforcing the code. The proliferation of codes of practice in the financial services industry shows that many businesses have determined that the benefits do outweigh the costs.

Costs may include funding the initial process to develop the code, revising policies and procedures, changing job descriptions, publicizing the code, ensuring compliance, and addressing instances of noncompliance. Depending on the environment in which the business operates, the cost of conducting a campaign to educate consumers, and possibly the government, about the code can be significant. Radio and television advertisements can be costly. Yet, without publicity, it may be difficult to generate sufficient awareness to boost sales, attract the attention of government regulators, and reap the trust dividend.

One benefit of adopting a code of practice is the perception of a higher degree of professionalism, making customers and regulators feel more confident about the company or industry. Another benefit may be product or brand differentiation in a competitive market. Benefits of transparency can also lead to greater customer loyalty, resulting in greater market share, savings realized from lower client turnover or reduced need for additional marketing efforts, or the ability to charge higher prices for a product or brand that is more highly valued than that of competitors. Adoption of a code of practice can also help thwart costly and cumbersome government regulation.

As with many policies, the intangible benefits of adopting a code of practice may be difficult to measure, especially for the smaller company. The cost/benefit analysis should take the public relations benefit into account, however, since it is one of the best reasons to adopt a code of practice for consumer protection. Letting the world know that a business treats its customers well, and showing how the company does so, can yield rewards in terms of sales, respect from government, and a positive image. (See Appendix A: New Century Financial Corporation Fair Lending Practices.)

Enforcement

Adopting a code of practice requires some mechanism of enforcement to ensure compliance. For an individual MFI that is adopting its own code, the mechanism may be as simple as a review by a senior manager, if customers perceive that as sufficient. A national network generally institutes a process of third-party dispute resolution, such as establishing an ombudsman's office to handle consumer complaints.[3] When a business is found to have abrogated its code of practice, the ombudsman can bring pressure to bear on the business to provide restitution to the consumer.

A less common mechanism for enforcement is for the government to grant a network, trade organization, or other third party with the power to regulate (see South Africa in the Application section below).

Whatever the enforcement mechanism, it must be perceived by consumers and other stakeholders as fair; but it must also be cost-effective for the MFI, network, or industry to avoid creating the same disincentives as government regulation.

Networks/Trade Associations

When the costs and benefits of adopting a code of practice are shared among most businesses in a trade or occupational group, the network or association representing that trade will often develop a code of practice that can be implemented by all businesses within an industry. Advantages of this arrangement include the shared cost of developing and enforcing a code among all businesses, as well as a higher degree of visibility and accountability. Where there is a threat of government regulation, an individual business's code of practice may not convince the government that regulation is unnecessary, but a code of practice adopted by all businesses in an industry may do so. The main disadvantage of adopting an industry-wide code of practice, from the perspective of business, is that the trade association takes on an enforcement role, decreasing the flexibility of business to deal with issues that arise. The decision to cede authority to a network or other third party is a major one for a business, and the advantages must be clear. (See Appendix B: A Model Code of Conduct for Bank Relations with Small- and Medium Sized Businesses [Canadian Bankers Association].)

[3] An ombudsman's office is a semi-independent office established by either an industry association or the government for the purpose of investigating complaints and assisting in achieving a fair settlement.

Application of Self-Regulation to Microfinance

Currently, microfinance is a largely unregulated industry. As microfinance institutions are evolving, however, from small, donor-funded programs to larger, leveraged institutions, including some that intermediate savings, governments are increasingly considering the need to regulate them. Prudential regulation is meant to protect customers from losing their savings and to ensure the stability of the financial system. Governments are generally ill equipped, however, to regulate MFIs: the cost is high, the systems are unique, and the risk to the banking system is relatively small (Christen and Rosenberg 2000, among others; see Wright 2000 for a skewering of conventional wisdom). Additionally, microfinance has traditionally been mainly a credit activity; thus, no regulation has been necessary.

Self-regulation is generally part of a regulatory package that may also include government and, in some cases, third-party regulation.[4] Some regulation is specific to microfinance institutions, while some covers all financial service institutions. Regulation may apply to all businesses (such as general consumer protection regulations, where they exist), or only to profit-making institutions. Governments almost always handle prudential regulation and supervision to ensure that financial institutions are financially sound. The cost of regulating many small institutions is so high, however, that in some countries, including Bolivia and Malawi, the government is considering prudential self-regulation of MFIs by an association or apex (Hannig and Katimbo-Mugwanya, eds. 2000).

Microfinance institutions and the associations that represent them, concerned with consumers who are marginalized by the formal banking sector, can share with government the responsibility for protecting consumers. In a recent paper, Graham Wright referenced Stuart Rutherford's idea to create a register in which MFIs would disclose their practices, including complaint resolution, to consumers, and which would require MFIs to publicize this information. Consumers would then be able to compare MFIs' practices and hold them accountable (or tell their friends of their experiences—good and bad). This is one form of self-regulation for consumer protection (Wright 2000); adoption and enforcement of a code of practice is another.

Because microfinance is a new industry, regulators should approach any type of regulation cautiously to avoid squelching innovations that will improve services and reduce costs for consumers. To address regulators' fears of potential abuse, however, MFIs and associations must overcome two obstacles to self-regulation: the credibility of the self-regulatory body and the cost.

[4] That is, neither the industry itself nor the government is directly responsible for regulatory oversight. Rather, a private company or nonprofit is engaged to regulate some or all aspects of an industry, usually under government authority. Such would be the case where a private accounting firm was to oversee the submission and review of annual financial statements by MFIs. There are also examples of industry employing third parties to oversee some aspects of self-regulation, such as the National Association of Securities Dealers (NASD) (Vartanian 1998).

Credibility

Credibility is essential where an MFI association hopes to preempt government regulation. Particularly in the field of microfinance, some candid regulators admit to having little understanding of the microfinance institutions they are being asked to regulate. Possibly they have even less understanding of consumer protection regulation. Where the government sees the need for regulation, however, even nonprudential regulation, it will not turn that function over to another institution unless it has complete confidence in the ability of that institution to self-regulate. In Indonesia, Bank Rakyat Indonesia (BRI) believes self-regulation by the Bank Perkreditan Rakyat (BPR) association, Perbarindo, would be an ideal complement to the Bank of Indonesia's supervisory functions; however, in BRI's view, Perbarindo is not currently ready to assume that task (Sukarno 2000).

As described earlier, there are benefits to self-regulation beyond preempting government-imposed rules. To earn the trust dividend, however, the self-governing body must still be credible in the eyes of its stakeholders. For an individual MFI, this means that customers must believe it will live up to its stated practice. For an association serving as a regulatory body for the industry it represents, this means that customers of represented institutions must have confidence that the association will enforce the code of practice for consumer protection. Member institutions must also have confidence that the association will enforce the code fairly and uniformly. This credibility is particularly difficult to win where one or more large MFIs dominate an association. The smaller MFIs may doubt the ability of the association to sanction a larger member.

Microfinance institutions and networks are beginning to gain credibility with the government. Partly, this credibility can be attributed to increased contact and mutual understanding as some large MFIs come under government supervision. MFIs and networks are also now hiring former bank regulators or government employees whose presence increases the visibility and contacts of the institution and the industry. Increased credibility is also the result of the work of networks that have succeeded in coalescing their member institutions around core principles. Some networks, such as Association of Microfinance Institutions of Uganda (AMIU), have already developed codes of conduct or codes of ethics to which members subscribe.

Of course, the most important pre-condition to credibility is capacity. The MFI or association must have the financial, human resource, and leadership capacity to ensure transparency in the business or industry, and to act when that transparency is compromised.

Cost

For self-regulation to be successful, the second issue—cost—must also be overcome. What is the likelihood that an MFI not yet profitable will spend scarce resources giving consumers a stick to beat them with? They will do this only if they see that the advantages outweigh the costs. These costs of creating and implementing a code of practice are frequently shared among all institutions benefiting from self-regulation. For example, in Colombia, the banking ombudsman's office—the *Defensoria*—was created to improve customer service in the banking industry. It is voluntary for MFIs and banks to belong, with the costs shared among member banks. Many banks clearly see the benefit of having the ombudsman's office handle complaints, but not all. The office reports that more than one-third of all complaints are rejected because they are against banks and MFIs that are not part of the *Defensoria*. These institutions have chosen not to pay for the *Defensoria*—probably because the cost outweighs the potential benefits. (Colombian Association of Banks and Financial Entities 2002).

The threat of costly and cumbersome government regulation will serve to help MFIs focus on the benefits of self-regulation. With or without such a threat, costs must be carefully considered.

Consumer Issues in Microfinance

As stated in the introduction, the potential harm of microfinance to consumers is well documented: low interest rates lead to non-price rationing, high interest rates impose an unfair burden on the poor, hidden costs take advantage of unsuspecting consumers—the list could go on.

Most microfinance institutions, even those that are commercially oriented, are rooted in humanitarian soil and driven by a desire to help people improve their lives. A quick look at the headlines in many countries, however, will demonstrate that the actions, if not the motives, of institutions serving the poor are being called into question. South Africa and Bolivia are two recent examples in which the government stepped in to curb abuses by financial services providers that claimed to be respecting microfinance principles. In both cases the resulting changes in regulations have been positive, creating a space for the growth of microfinance in those countries.

South Africa

In South Africa, an exemption to the interest rate cap established by the Usury Act produced a boom of microfinance and consumer credit organizations from 1992 through 1999. Some of those organizations grew very rapidly, without adequate concern for loan portfolio standards. Clients naturally took advantage of the newly available credit opportunities; for some it was their first opportunity to take a loan. This combination of lax portfolio management and high demand made arrears an imminent threat. The situation may have remained just another story of unhealthy microfinance institutions closing their doors as arrears eroded the quality of their portfolio. In South Africa, however, the situation exploded when consumers panicked at the unorthodox collection practices of some consumer credit organizations.

By 1999, a generalized public concern for the perceived exploitation by financial institutions was evident. A draft report commissioned by South Africa's Department of Trade and Industry (DTI) cited the real or perceived exploitation of clients by lenders and high interest rates leading to a "debt spiral" (over-indebtedness) as the department's top two concerns. A third concern relates to the undesirable effects of government regulation noted earlier: the negative impact of regulation (specifically interest rate caps) on innovation and, in this case, investment (DTI n.d.).

In September 2000, the government responded by creating the Micro Finance Regulatory Council (MFRC), a private organization with powers to regulate all lenders operating under the interest rate cap exemption. Those lenders must follow MFRC rules designed to protect consumers from unscrupulous lenders. Rules include reporting to a national credit bureau, avoiding certain collection practices, and training staff in consumer rights issues (Micro Finance Regulatory Council 2002). Predictably, the business community did not easily accept these new restrictions and challenged the legislation in court, unsuccessfully (DTI n.d.).

Bolivia

In Bolivia, a similar tension existed between financial services providers and their customers, but the response was different. Bolivia had also experienced rapid growth in the number of microfinance providers during the 1980s and early 1990s. In 1995, a microfinance law was passed that opened up the possibility for non-bank institutions to intermediate savings. During the late 1990s, a deep recession made it difficult for customers to repay the loans that the consumer credit organizations chartered under the microfinance law had given them so easily. Those lenders had promoted over-indebtedness by offering easy additional loans in an effort to gain market share from traditional microfinance organizations.

A small debtor association was created. It solicited those who thought they were being mistreated to join in protest, complaining that some lenders were charging interest on top of interest and that collection practices were unfair. They claimed that loans were rescheduled without notification, and collateral was being repossessed without sufficient consultation.

Initially, the Superintendency of Banks and Financial Entities (SBFE) did not see that the antipathy between business and consumers had spilled over into the public arena and required mediation. The SBFE contended that the matter should be handled between the organizations and their customers. Like the Denver, Colorado, mothers who demonstrated in 1960 (and countless other consumer movements demanding protection), a group of customers took to the streets. They stormed the SBFE offices and threatened to blow up the building if their demands were not heard. Finally agreeing to examine the complaints, authorities recognized that some abuses had taken place (although in general, organizations that were regulated were operating under the law). The SBFE created guidelines for conflict resolution between customers and financial institutions. If the SBFE cannot resolve a situation, they refer it to courts (Finrural 2001).

Pre-empting Conflict

In both South Africa and Bolivia authorities eventually realized that prudential/economic norms, such as interest rate caps or smaller lending limits, were not the solution, but that consumers needed some protection from unscrupulous lenders. In each case, the government was in the uncomfortable position of having to intervene on an emergency basis, and the microfinance industry image was tarnished. Similar conflicts and their repercussions may be avoided if microfinance institutions and the networks that represent them formulate, adopt, and publicize a code of practice for consumer protection. In this way, all parties (MFI employees, customers, and government) will understand how the consumer is to be treated, and the consumer will know the available recourse.

SEEP Template

The SEEP Consumer Protection Task Force has developed a template and discussion guide to help microfinance institutions and networks establish a code of practice to address such consumer issues.[5]

Implemented at the MFI level, a transparent code of practice would enable consumers to differentiate between those that disclose their practices related to consumer issues and those that do not. Consumers would then be able to compare the different policies of transparent MFIs to determine the institution that best meets their needs.

At a network or association level, all network members could adopt a similar code, thereby increasing the confidence of consumers in all member institutions and increasing the government's confidence in the ability of the microfinance industry to regulate itself.

Box 2 outlines the six main themes addressed by the template: Commitment, Operations/ Products and Services, Transparency, Community Engagement, Accountability, and Local Laws. Each of these is followed by a brief explanation of the importance of the theme for microfinance and a few examples of discussion points contained in the guide. Only by transparently holding itself to the highest standards of consumer protection will microfinance emerge as a true industry worthy of the trust of the government and, most importantly, the consumer.

[5] Available from The SEEP Network. www.seepnetwork.org.

Box 2. SEEP Consumer Protection Template

Commitment

Adopting a Code of Practice for Consumer Protection makes an important statement about an institution's commitment to transparency and fair lending. Articulation of the commitment helps all stakeholders understand why the institution is adopting the code.

> ***Why is the code of practice important? Who is the audience? What is the expected objective?***

Operations/Products and Services

Microfinance seeks to serve a relatively vulnerable population. Those consumers should be protected from the inappropriate marketing and distribution of some products and services, as well as from unfair pricing and collections practices.

> ***Disclosing collection practices can help consumers understand the serious nature of the contract they have entered into. For example, where informal debt collection practices are the norm, a customer may believe she is being treated harshly if an MFI engages professional services to attempt to collect the debt. The consumer should also be advised in advance if a debt obligation could result in the sharing of personal information, such as reporting to a credit agency or other MFIs.***

Transparency

MFIs are increasingly aware of the need for transparency in their dealings with regulatory bodies and donors, but not necessarily with their customers. Highly transparent MFIs require a higher degree of professionalism than those that do not disclose; but in return, they should enjoy a greater trust dividend on the part of their clients.

> ***The type and frequency of information disclosed to the public are indicative of the openness of the MFI. Information useful to consumers includes statements of the financial condition of the MFI, but also the policies and procedures established to address issues such as conflict of interest or internal controls.***

Community Engagement

Some MFIs have recently been accused of being monolithic, self-serving institutions that are unconcerned about the needs of the customer. MFIs should disclose how they engage their clients and the communities in which they operate.

> ***Not all MFIs have held themselves to the highest standards of customer satisfaction, although this is changing. Customers should know if the MFI actively seeks customer feedback, how they can express dissatisfaction in an appropriate way, and how the MFI will respond.***

Accountability

While issues of regulation and supervision of MFIs have been given significant attention recently, most MFIs are unregulated; and those few that are subject to prudential regulation do not necessarily disclose to consumers how they are accountable. Such an environment opens MFIs to charges that they are not accountable for their actions.

> ***How are management and staff accountable for the policies designed to protect consumers?***

Local Law Exceptions

> ***What statements need to be included to ensure this document is not inconsistent with local law in the countries in which we do business?***

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Appendix A

New Century Financial Corporation Fair Lending Practices

Avoidance of Questionable Products and Practices

New Century does not offer products or engage in practices frequently cited as "predatory." This includes:

- Loans with terms containing balloon payments, negative amortization or reverse mortgages
- So-called "asset-based financing" or "packing" loans with unnecessary fees and products
- Loans for home improvements if proceeds are payable directly to a contractor
- High cost mortgage products as defined under Section 226.32 of Regulation Z (12 CFR 226.32)
- So-called "flipping" or "churning"—the practice of aggressively re-soliciting borrowers for the sole purpose of refinancing for fees

Balanced Consumer Marketing

Our consumer marketing efforts generally consist of direct mail within a 50-mile radius of our branch locations. This method yields a balanced number of loan applications across racial, ethnic and income categories. As a result, our applications and funded loans are strongly representative of the broader communities we serve.

Fee Limits

Our retail and wholesale divisions have maximum Loan Fee policies that are periodically reviewed and adjusted to the market. These limits are designed to exclude loans with fees or rates that are not commensurate with the work performed or the risk assumed.

Procedures to Prevent "Loan Flipping" Transactions

New Century strives to identify and prevent sham loan transactions, also known as "loan flipping". In these schemes, a third-party buyer purchases a property and immediately resells it at an inflated price to an unwitting consumer, based on an inflated or fraudulent appraisal. The Purchase Money Checklist is specifically designed for use by loan underwriters to discover telltale signs of flip transactions. Rigorous verification of borrowers applying for multiple loans also plays an important part in this process.

Appraisal Review Process

Many unethical practices hinge on an inflated appraisal given by an incompetent or corrupt appraiser. We continue to enhance our already rigorous appraisal review process to further reduce the risk that a loan will be funded based on an inappropriate appraisal.

Auditing Loan Production

QA and Compliance — Our quality assurance and compliance audits involve a statistically valid sampling of loan production from our origination divisions. The audits are another way we identify potential problems in our origination process and determine whether corrective action is needed.

Investor Rejects — We also audit loan files rejected by the investors who purchase our loans in the secondary market to determine whether they reflect any origination-related problems.

Predatory Lending Watch — Special audits will also be conducted of loans with risk factors associated with possible predatory lending practices. Key legal, compliance and risk management staff, and Executive Management, will regularly review results to ensure that we are complying with our Best Practices.

Providing Exemplary Customer Service

Calling New Customers — Our Servicing Department welcomes new borrowers within a few weeks of loan origination by phoning them to verify the basic loan information and to ensure that they understand the loan terms, payment amount and payment date. These calls are an important way for us to identify any origination-related problems promptly.

Measuring Customer Satisfaction — In addition to conducting our own customer surveys, we periodically hire a third party to survey a random sampling of our customers. These customers include ones whose applications were declined or withdrawn. Surveys ask about our service, as well as about the customer's dealings with other parties such as the broker or the appraiser. To date, those surveys have reflected an extremely high level of satisfaction with New Century's service.

Appendix B

Model Code of Conduct for Bank Relations with Small- and Medium-Sized Businesses (Canadian Bankers Association)

Preamble

Canada's chartered banks recognize the important role that small and medium-sized enterprises (SMEs) play in Canada's economy. The chartered banks also recognize that they have an important and unique role to play in fostering the growth of SMEs in Canada.

In the interest of promoting a healthy and effective relationship between SMEs and the banking community, the Canadian Bankers Association and its members, the Chartered Banks of Canada have developed this model code of conduct which will serve as a minimum standard for bank dealings with SMEs. The key elements of this model code of conduct will be incorporated into individual bank codes. This model code of conduct and the individual bank codes will not limit the legal rights of any customer or bank.

Individual Bank Codes

- Each bank will apply its own bank code to the business activities it has with its small and medium-sized business customers.
- Individual bank codes will contain the four major points outlined in this industry model code of conduct, which are:
  - Openness
  - Accountability
  - Credit Process
  - Complaint Handling

Openness

- Banks will make their codes available to their customers at branches where commercial business is conducted.
- Banks will provide the customers with documents, including contracts that are written in clear and understandable language.
- Banks recognize the need for open communications with their customers. Banks will outline the joint responsibilities that are part of the customer-bank relationship to help make sure that open communications take place.

Accountability

- Each bank will identify a senior officer at the national level who is responsible for making sure the code is implemented and followed by bank employees.
- Managers and account managers of each bank will carry out the principles of its code.
- Each bank will file a copy of its code with the banking industry's regulator, the Office of the Superintendent of Financial Institutions.

Credit Process

Applications for Credit

- Banks will make the following information available to each customer for the purposes of obtaining business credit:
- Directions on how to apply for credit
- An explanation of the requirements needed to obtain bank credit (such as collateral security)
- Guidelines on how to prepare a business plan
- An estimate of how to prepare a business plan
- An estimate of how long it will take before a credit decision will be made.

Credit Approval

- Each credit application will be judged on its own merits.
- When an application for credit is approved, the bank will inform the customer about the terms and conditions of the financing including the information and documentation needed by the bank both before and after the loan is granted. This information will be provided in writing should the customer request.

If Credit Is Declined

If an application for credit is declined, the bank will inform the customer about:

- The main reason(s) for the decision
- The requirements necessary for the bank to reconsider the application
- Available information on alternative sources of financing which could include government programs, venture capital, etc.

Changing Circumstances in the Credit Relationship

- Sometimes customers who have a credit relationship with their bank experience a significant change in their business, which could include financial difficulty. In these circumstances, banks will carefully review the existing arrangement before deciding if any action should be taken.
- If there are changes in the credit relationship, banks will inform customers as soon as possible about the need for on-going, additional information. Banks will give customers a reasonable opportunity to provide this information.

- Under normal circumstances, banks will provide their customers with a minimum of 15-calendar days' notice of any bank actions taken because of a change in the credit relationship.
- Each bank must inform its customer when changes are made to the terms, conditions, fees or lending margins that are specific to that customer's credit relationship with the bank.

Complaint Handling

- Each bank will ensure that a complaint resolution procedure is available for use by its small and medium-sized commercial customers. Each bank will provide its customers with the information they need to use their bank's complaint resolution procedure. Each bank will appoint a senior officer at the national level who is ultimately responsible for the resolution of complaints.
- If customers have a general complaint or if they believe their bank has not met the standard of conduct outlined in the bank's code, a customer may submit a complaint under the bank's complaint resolution process.
- Banks will respond to customer complaints as quickly as possible. Banks will also inform the customer approximately how long it will take to respond to their specific complaint.
- If a complaint is not resolved to the satisfaction of the customer, the bank will provide the customer with the reason(s) for the bank's decision.
- If a complaint is about the loss or reduction of a customer's credit or enforcement by the bank on its security and the complaint has not been settled to the satisfaction of the customer in the complaint resolution procedure, the bank will make an alternative dispute resolution (ADR) process available to the customer. This ADR process will involve a neutral moderator, will be confidential, and will be accessible in terms of cost and procedures.
- Each bank's code of conduct will inform customers that they may express their concerns to the Financial Consumer Agency of Canada (FCAC).
- Banks will make the . . . Financial Consumer Agency of Canada address available to their customers . . . .