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## Helping Microfinance Become Commercially Sustainable\*

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### I. INTRODUCTION

Microfinance primarily refers to the making of small loans to low-income individuals and the poor, to enable them to start or expand small businesses.<sup>1</sup> Currently, most microfinance loans are made through nonprofit microfinance institutions (MFIs) that receive donor money.<sup>2</sup> However, donor-funded loans can account for only a small portion of the need. Microfinance analysts estimate, for example, that total market potential is \$300 billion,<sup>3</sup> of which only ten percent is currently being captured.<sup>4</sup> Increasingly, the shortfall in funding is

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1. Neil MacFarquhar, *Banks Making Big Profits from Tiny Loans*, N.Y. TIMES, Apr. 13, 2010, at A1 (describing how Muhammad Yunus, who recently won the Nobel Prize in 2006 for conceiving of microfinance, and others have noticed how banks and financial institutions now dominate the microfinance field, with some banks charging the poor very high interest rates).

2. Steven L. Schwarcz, *Disintermediating Avarice: An Inquiry into Commercially Sustainable Microfinance*, 2011 U. ILL. L. REV. (forthcoming 2011) (manuscript at 3), available at [http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1024&context=working\\_papers](http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1024&context=working_papers).

3. Harald Hüttenrauch & Claudia Schneider, *Securitisation: A Funding Alternative for Microfinance Institutions*, in NEW PARTNERSHIPS FOR INNOVATION IN MICROFINANCE 299, 322 (Ingrid Matthäus-Maier & J.D. von Pishke eds., 2008) (estimating that total demand for microloans exceed \$300 billion).

4. Drew Tulchin, *Positioning Microfinance Institutions for the Capital Markets 1* (Soc. Enters. Assocs., Working Paper No. 5, 2004). Standard & Poor's has estimated that of the one-and-a-half billion people potentially eligible for microfinance loans, only one hundred million people—less than seven percent—receive them. STANDARD & POOR'S,

being met by commercial banks.<sup>5</sup> But commercial-bank intermediation is expensive, with a global average effective interest rate (on commercial microfinance loans) reported to be as high as thirty-seven percent.<sup>6</sup>

I have separately argued that microfinance lending can benefit through securitization.<sup>7</sup> Securitization envisions the creation of a special-purpose vehicle (“SPV,” sometimes called a special-purpose entity or SPE) that effectively replaces commercial banks as intermediaries of funds from capital market sources (such replacement being called “disintermediation”). Unlike commercial banks, the SPV is not intended to be profit-making.<sup>8</sup> The SPV issues securities to capital market investors<sup>9</sup> and uses the proceeds to acquire rights to payment, which are intangibles, under loans, leases, and other financial assets. These intangible rights, in turn, constitute the source of repayment of the SPV’s securities.<sup>10</sup>

Securitization can be applied to microfinance in two ways.<sup>11</sup> The more straightforward way, which to some extent is already occurring, is to securitize an MFI’s donor-funded microfinance loans in order to regenerate funding for

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MICROFINANCE: TAKING ROOT IN THE GLOBAL CAPITAL MARKETS 9 (2007).

5. MacFarquhar, *supra* note 1.

6. *Id.* (reporting “a global average of about 37 percent in interest and fees”).

7. Schwarcz, *supra* note 2 (manuscript at 6).

8. *See, e.g.*, Comm. on Bankr. & Corporate Reorganization, N.Y.C. Bar Ass’n, *New Developments in Structured Finance*, 56 BUS. LAW. 95, 132 (2000) (observing that SPVs are not intended to profit, so taxes should not be an issue).

9. These investors are usually located in major money centers. *But cf.* Hüttenrauch & Schneider, *supra* note 3, at 323 & n.49 (observing that ProCredit Bank AD, Bulgaria was able to issue microfinance-loan-backed bonds in local markets); Susan Davis & Rod Dubitsky, *Microfinance Meets Wall Street*, FORBES (Mar. 26, 2008, 6:00 AM), [http://www.forbes.com/2008/03/22/brac-microfinance-creditsuisse-oped-cx\\_sdrd\\_0326brac.html](http://www.forbes.com/2008/03/22/brac-microfinance-creditsuisse-oped-cx_sdrd_0326brac.html) (describing how BRAC, led by Citibank, issued microfinance-loan-backed securities locally in Bangladesh). Some SPVs are located in Luxembourg because of its favorable securitization laws that allow a single SPV to carry out many different transactions by multiple, legally separated groups within the same SPV. Christopher J. Carolan & Madeleine M.L. Tan, *Microfinance & Securitization: A Profitable Partnership for Socioeconomic Development*, INT’L SECURITIZATION & FIN. REP., Apr. 15, 2008, at 12.

10. For a more complete discussion of securitization, including the transactional steps mentioned above, see generally STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (3d. ed.2007 & Supp. 2010) [hereinafter *STRUCTURED FINANCE*]; Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133 (1994). Securitization is economically efficient when the interest-rate cost saving achieved through this disintermediation more than offsets the transaction costs of the securitization. *Id.* at 137-38 (observing that transaction costs, which include the cost of creating the SPV and sometimes also the cost of obtaining a rating on its securities, can vary over a wide range depending on the securitization structure).

11. Schwarcz, *supra* note 2 (manuscript at 8).

the MFI to make additional loans (“regenerative securitization”).<sup>12</sup> A more innovative way would be to fund new microfinance lending through the capital markets without expensive commercial-bank intermediation (“transformative securitization”).<sup>13</sup>

## II. THE PROBLEM

Either form of securitization, however, faces a problem under commercial law. To successfully securitize microfinance loans, the MFI originating the loans would have to transfer the loans to the SPV. That transfer will often have to constitute a sale.<sup>14</sup>

The law governing that transfer will likely depend on the MFI’s location.<sup>15</sup> For MFIs located in the United States, United States law would apply.<sup>16</sup> But for an MFI located in Country X, the law of Country X would likely be applicable.<sup>17</sup> In that case, investors would want to ensure that the transfer of the microfinance loans is protected from creditors of the MFI under the law of Country X. Country X could well be the country where the end-borrowers are located if, for example, the MFI must be locally licensed there to make the loans.

## III. PERFECTION AND PRIORITY

That calls into question whether Country X law is sufficiently developed to address the sale or other transfer of intangible rights like microfinance loans—which are essentially rights to payment—and, if so, whether the SPV or the MFI is required to take steps to protect or “perfect” the transfer. The rationale for requiring protective steps is to prevent the transfer of intangible rights from

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12. *Id.*

13. *Id.*

14. Steven L. Schwarcz, *The Universal Language of International Securitization*, 12 DUKE J. COMP. & INT’L L. 285, 291 (2002).

15. UNITED NATIONS, U.N. CONVENTION ON THE ASSIGNMENT OF RECEIVABLES IN INT’L TRADE, at 15, U.N. Sales No. E.04.V.14 (2004), available at <http://www.uncitral.org/pdf/english/texts/payments/receivables/ctc-assignment-convention-e.pdf> [hereinafter U.N. CONVENTION] (making the law of the transferor’s jurisdiction applicable when determining priority of claimants’ rights to receivables); see U.C.C. §§ 9-301(1), 9-305(c) (2008) (the location of the transferor determines the jurisdiction whose law governs perfection); Schwarcz, *supra* note 14, at 292.

16. Schwarcz, *supra* note 2 (manuscript at 23).

17. *Id.*

being regarded as fraudulent vis-à-vis third parties, such as creditors of the MFI, who cannot actually see the transfer.<sup>18</sup>

In the United States, a transfer of intangible rights is normally perfected by filing, in a public registry, a description of the transferred assets.<sup>19</sup> In many other countries, however, perfection procedures for transferring intangible rights, when they exist, are unclear or impractical—such as requiring the obligors on the intangible rights (in our case, the borrowers on the microfinance loans) to be notified of the transfer.<sup>20</sup> Moreover, in countries where transfers are perfected without public registration or some other form of objectively ascertainable public notice, a transferee—in our case, the SPV—cannot know that its interest in the intangible rights will have priority over third-party interests.<sup>21</sup> This can create a fraud risk, enabling a transferor to purport to transfer the same rights to multiple parties.<sup>22</sup> Perfection procedures that are unclear or impractical or that enable fraud will discourage commercial transfers of intangible rights,<sup>23</sup> thereby discouraging securitization of microfinance loans.

In Ghana and the Philippines, for example, the perfection requirement “has emerged as a substantial constraint to rural credit access.”<sup>24</sup> Determining if there are prior superior claims on assets pledged as collateral can also be very difficult in Latin America.<sup>25</sup> In Uruguay, a transferee cannot search records by the name of the transferor but must know the date of any prior transfer.<sup>26</sup> In Bolivia, a transferee of intangible rights must look through an entire registry to determine if there have been prior transfers that have priority.<sup>27</sup> Many other

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18. See, e.g., *Benedict v. Ratner*, 268 U.S. 353 (1925) (examining whether transfers of intangible rights can be fraudulent, creating “secret liens”).

19. See U.C.C. § 9-310 (requiring the filing of financing statements for perfection).

20. Schwarcz, *supra* note 14, at 292-93.

21. *Id.* at 293.

22. *Id.*

23. *Id.* at 294. For an analysis of public registration for transfers of intangible rights, see Steven L. Schwarcz, *Towards a Centralized Perfection System for Cross-Border Receivables Financing*, 20 U. PA. J. INT'L ECON. L. 455 (1999).

24. Joselito Gallardo, *A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines* 31 (The World Bank, Working Paper No. 2755, 2002).

25. Glenn D. Westley, *Can Financial Market Policies Reduce Income Inequality?* 32 (Inter-Am. Dev. Bank, Sustainable Dev. Dep't Technical Papers Series No. MSM-112, 2001), available at <http://info.worldbank.org/etools/docs/library/128760/Can%20Financial%20Markets%20Reduce%20Income%20Inequality.pdf>.

26. *Id.*

27. *Id.*

Latin American countries have even less developed transfer mechanisms.<sup>28</sup> The problem has become so important that The World Bank is attempting to address it.<sup>29</sup>

These problems could be exacerbated when microfinance loans are transferred as part of a securitization. Microfinance loans are often made to individuals in a neighborhood peer group, who jointly and severally become obligated for repayment.<sup>30</sup> Also, because microfinance loans are typically made in small amounts, a commercially viable securitization may have to include thousands of microfinance loans to offset transaction costs. If the relevant MFI's jurisdiction requires notification of obligors for perfection, that would require many thousands of notices.

This essay next examines how the Uniform Commercial Code ("UCC") in the United States facilitates the transfer of intangible rights—an approach that, with principled modifications, other nations might consider examining in order to help facilitate the securitization of microfinance loans.

#### IV. THE UNITED STATES LEGAL FRAMEWORK

In the United States and, in the author's experience, also in many other countries, transfers of intangible rights are generally regarded as either sales or transfers for security.<sup>31</sup> Article 9 of the UCC governs transfers for security of

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28. See *id.*; cf. SWATI R. GHOSH, EAST ASIAN FINANCE 19 (2006) (finding that Singapore, Hong Kong, and Malaysia have adequate legal frameworks for securitization).

29. See Arnold S. Rosenberg, *Where to File Against Non-U.S. Debtors: Applying UCC § 9-307(c)[Rev] to Foreign Filing, Recording, and Registration Systems*, 39 UCC L.J. 109, 262 (2006) (noting that The World Bank considers a filing system important to securitization and "continue[s] to pressure debtor countries to establish filing systems and a supporting legal framework"); Gallardo, *supra* note 24, at 4 (observing that The World Bank has been helping countries to adopt comprehensive legal frameworks for transferring intangible rights, including modernizing registry systems); GLOBAL FIN. MKTS. DEP'T, INT'L FIN. CORP., SECURITISATION IN RUSSIA (2005), available at [http://www.ifc.org/ifcext/home.nsf/Content/Securitization\\_in\\_Russia](http://www.ifc.org/ifcext/home.nsf/Content/Securitization_in_Russia) (reporting the findings and advice of a World Bank Group delegation that advised Russia in drafting new securitization laws).

30. Beatriz Armendáriz de Aghion & Jonathan Morduch, *Microfinance Beyond Group Lending*, 8 ECON. OF TRANSITION 401, 402 (2000) (describing group lending as a practice by MFIs that is "typically comprised of three to seven neighbours"); Begoña Gutiérrez-Nieto, Carlos Serrano-Cinca & Cecilio Mar Molinerob, *Microfinance Institutions and Efficiency*, 35 OMEGA 131, 132 (2007); cf. Klaus Abbink, Bernd Irlenbusch & Elke Renner, *Group Size and Social Ties in Microfinance Institutions*, 44 ECON. INQUIRY 614, 615-16 (2006) (stating how MFIs, when adopting jointly-obligated schemes, must balance insuring individual risks against an individual's reliance on other borrowers to repay the loans that gives the individual an incentive to free-ride).

31. There can be, of course, other types of transfers, such as transfers in trust or into

most assets, including intangible rights. Article 9's basic function is to perfect and give priority, in a simple and low-cost manner, to these transfers. It normally accomplishes this, as mentioned, by having a party to the transfer file a description of the transferred assets with a public registry.<sup>32</sup> Once so filed, the transferee secured by the assets (the "secured party") can determine its priority by examining if there are any other filings describing those assets.<sup>33</sup> Transferees who file first obtain first priority (often referred to as first-in-time, first-in-right).<sup>34</sup>

More significant to this essay, the UCC expands Article 9's perfection-and-priority filing system to also cover transfers of intangible rights<sup>35</sup> that constitute sales, not merely transfers for security.<sup>36</sup> This expansion was intended to bring these sales within the UCC's simple and low-cost perfection and priority rules that govern secured transactions.<sup>37</sup> The rationale for doing this was to facilitate modern commercial finance, including securitization, in which sales of intangible rights are critical.<sup>38</sup> Thus, under Article 9, sales of these intangible rights were intended to be perfected and to obtain priority in the same manner as if those sales were transfers as security—simply by filing a financing statement in a public recording system ("notice filing"). This is the principle that—as applied to sales of intangible rights—should inform microfinance, as discussed below.

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escrow.

32. See *supra* note 19 and accompanying text.

33. U.C.C. § 9-322 (2008).

34. U.C.C. § 9-322 (2008).

35. More precisely, intangible rights *for the payment of money*.

36. See U.C.C. § 9-109(a)(3) (2008).

37. See PERMANENT EDITORIAL BD. FOR THE U.C.C., COMMENTARY NO. 14 (SECTION 9-102(1)(b)) FINAL DRAFT (June 10, 1994) (explaining that the "reason for subjecting both sales and secured transactions to [UCC] Article 9 was to inform third parties of existing interests in a debtor's receivables and to provide protection for all types of assignments of receivables"; and adding a paragraph to Official Comment 2 to section 9-102 to explain that "Article 9 applies . . . to sales of [intangible rights] primarily to incorporate Article's 9's perfection rules").

38. Cf. Schwarcz, *supra* note 23, at 455 (observing that intangible rights may constitute one of the largest categories of assets transferred in cross-border financing). An Official Comment to UCC section 9-109 states that the scope rule of subsection (a)(3) thereof is intended to "avoid[] difficult problems of distinguishing between transactions in which a receivable secures an obligation and those in which the receivable has been sold outright. . . . [Because] [i]n many commercial financing transactions the distinction is blurred." U.C.C. § 9-109 cmt. 4 (2008). This rationale is not completely convincing, however, because anyone having any question as to whether a given transaction is a secured transfer or a sale could always perfect *as if* it were a secured transaction.

There is, however, a technical caveat. Due to what I believe were misguided lobbying efforts,<sup>39</sup> the 2001 revisions to UCC Article 9 undermined the notice-filing principle by providing, in new sections 9-309(3) & (4), that sales of “payment intangibles” and of promissory notes are “perfected when they attach,” meaning they are perfected automatically without the need to file financing statements in a public registry.<sup>40</sup> Payment intangibles and promissory notes are terms that, if applied to microfinance, would include most if not all microfinance loans.<sup>41</sup>

Automatic perfection, like notice filing, makes it feasible to sell intangible rights.<sup>42</sup> However, automatic perfection, *unlike* notice filing, prevents transferees, such as an SPV, from knowing whether its interest in the purchased intangible rights will have priority over third-party interests, creating a fraud risk.<sup>43</sup> My article advocates that microfinance should be informed by applying the notice-filing principle of the UCC—not the distortion of that principle created by automatic perfection—to sales of intangible rights.

#### V. APPLICATION TO MICROFINANCE

To control lending costs, local MFIs with knowledge about the microfinance borrowing community typically must originate microfinance loans.<sup>44</sup> They therefore would be selling these loans to SPVs.<sup>45</sup> The law of the nation where a microfinance borrowing community, and thus the loan-originating MFI, is located would thus govern perfection of the sale of those loans.<sup>46</sup>

Nations that wish to expand the availability of low-cost microfinance lending to their local communities are therefore the very nations that should consider perfecting sales of intangible rights through notice filing. A nation could do this merely by enacting a law that enables sales of microfinance loans

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39. See generally Steven L. Schwarcz, *The Impact on Securitization of Revised UCC Article 9*, 74 CHI.-KENT L. REV. 947 (1999) (contributing to that Law Review’s Symposium on Revised Uniform Commercial Code Article 9, I explain why those lobbying efforts were misguided).

40. See U.C.C. § 9-309 cmt. 4 (2008).

41. Where microfinance loans are not evidenced by promissory notes, the intangible rights to payment under the loan agreements would constitute payment intangibles. See U.C.C. § 9-102(a)(61) (2008).

42. Compare *supra* text accompanying notes 19-20 (discussing unclear or impractical perfection procedures for transferring intangible rights).

43. See *supra* notes 21-22 and accompanying text.

44. Schwarcz, *supra* note 2 (manuscript at 26-28).

45. See *supra* note 14 and accompanying text.

46. See *supra* note 15 and accompanying text.

to be perfected—that is, protected from creditors of the transferor—by a simple and low-cost filing in a public recording system.

There are other possible approaches. For example, drafters of the United Nations Convention on the Assignment of Receivables in International Trade (the “UN Convention”) were unable to reach consensus on substantive rules for establishing perfection and priority of cross-border transfers of intangible rights, addressing these issues instead through conflict-of-laws rules.<sup>47</sup> The UN Convention makes the law of the assignor’s location govern perfection and priority disputes,<sup>48</sup> but it also offers a choice among three substantive law priority systems: filing in a public recording system (in the Convention called a “notice-filing system”), a notification-of-the-debtor system, and a system based on the time of conclusion of the contract of assignment.<sup>49</sup> A public recording system, however, would avoid the notification-of-the-debtor problems that are exacerbated by microfinance securitization<sup>50</sup> and would also avoid the potential for fraud that is created by a system, such as time-of-conclusion-of-the-contract-of-assignment, that does not require objectively ascertainable public notice.<sup>51</sup>

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47. U.N. CONVENTION, *supra* note 15, at 40-41.

48. See Spiros V. Bazinas, *Multi-Jurisdictional Receivables Financing: UNCITRAL’s Impact on Securitization and Cross-Border Perfection*, 12 DUKE J. COMP. & INT’L L. 365, 380 (2002). Location is defined by the assignor’s place of business, and if the assignor does business in more than one country then the location is the assignor’s place of central administration (principal place of business). U.N. CONVENTION, *supra* note 15, at 32.

49. Bazinas, *supra* note 48, at 383.

50. See *supra* notes 29-31 and accompanying text.

51. See *supra* notes 20-22 and accompanying text.