

Reserve Bank of Zimbabwe

CONSUMER EDUCATION AND AWARENESS BULLETIN



- **MAIN FEATURES OF A LOAN AGREEMENT**
- **OVER-INDEBTEDNESS**
- **DISPUTE RESOLUTION**



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1. INTRODUCTION

- 1.1. This Bulletin focuses on the characteristics of Loan Agreements or Loan Contracts; causes of over-indebtedness and how to avoid over-indebtedness; and gives information on dispute resolution mechanisms available to consumers of financial services.

2. MAIN FEATURES OF A LOAN AGREEMENT/LOAN CONTRACT

- 2.1. Loan agreements (also known as Credit Agreements) are legal documents that detail the terms and conditions of the business relationship that exists between a lender and a borrower. Agreements of this type are used whenever a bank or a microfinance institution extends a loan to a customer.
- 2.2. A credit agreement provides information regarding the steps each party may take in the event that the other party fails to meet the commitments identified in the text of the agreement. Below are some of the main provisions found in a loan agreement.

Recitals...

- 2.3. The recitals (frequently introduced with the word “*Whereas*”) found at the beginning of a loan agreement describe the general business understanding between the parties to the agreement. The borrower should always confirm that these statements reflect its understanding of the background to, and operation of the loan.

Definitions...

- 2.4. Before reviewing the provisions of a loan agreement, a borrower should make sure they understand the meaning of terms used in the agreement. Definitions of these terms are usually provided in one section of the agreement called ‘Definitions’, but they are sometimes found throughout the agreement.
- 2.5. There is no requirement that a defined term should be given its common sense meaning. The person drafting the agreement may choose to take an everyday word and give it a particular

meaning. Thus, readers should not assume that they understand the meaning of defined terms without checking the contextual definitions.

Conditions...

- 2.6. Loan agreements may contain what are called *conditions precedent*. These are conditions that must be satisfied before the agreement creates a legally binding obligation on the lender and before the lender is required to disburse the committed funds.
- 2.7. Although in most cases conditions precedent are in relation to the borrower, sometimes loan agreements will include conditions precedent that require the lender to comply with certain conditions or provide the borrower with certain documentation.

Disbursements...

- 2.8. The disbursement clause sets forth the manner in which loan funds will be provided to the borrower. The clause assures the borrower that if specified conditions are met, the funds committed by the lender will be credited by a specific day and time to the account specified by the borrower. This clause also specifies the period for, and number of, disbursements.

Voluntary Prepayment of Loan Principal...

- 2.9. This clause, sometimes also called the early repayment clause, governs whether the borrower may prepay the loan at their own discretion. Unless the agreement explicitly allows prepayment, loans may not be prepaid. Sometimes the terms of the agreement expressly prohibit prepayment. It is normally desirable for the borrower to negotiate the right to prepay a loan.
- 2.10. It is not unusual, however, for a lender to require the borrower to pay a fee in exchange for the borrower’s right to prepay. The prepayment fee is levied to compensate the lender on the foregone interest (loss of interest due to accelerated repayments) which arises from a short loan period and reduced principal amount.

Interest Rate...

- 2.11. A loan accessed from a financial institution may carry either a *fixed* or *floating* rate of interest.

2.12. *Fixed rate* – A fixed interest rate is one that remains the same over the loan tenure. The rate is fixed at the inception of the loan and does not vary. The primary advantage of a fixed rate loan is the borrower's ability to secure a particular interest rate at a particular time.

2.13. *Floating rate* – This is also known as variable rate or adjustable rate. The interest rate can change during the life of the loan. In some cases the interest rate can be linked to inflation or other index.

2.14. The primary advantage of a floating rate loan to the borrower is that lenders generally charge lower initial interest rates than they do for fixed rate loans, while the primary downside of a variable rate loan is that the borrower may have to make significantly different payment amounts during the life of the loan.

Interest on Late Payments...

2.15. Many loans specify that the interest rate on *overdue* payments of principal or interest will be higher than the normal rate applicable to the loan. The purpose of this increase is to compensate the lender for the additional risk and administrative expense involved in a loan that is now, by definition, in default. The interest rate increase also is designed to discourage the borrower from defaulting on scheduled loan repayments.

Fees...

2.16. This provision gives the lender additional compensation for arranging and maintaining the loan. Potential fees include arrangement or establishment, insurance and prepayment fees.

2.17. However, up-front fees paid to lenders cannot be recouped even if the loan is prepaid or accelerated shortly after it is drawn. In addition, on rollover, fees payable will be on the top up and not the limit, where the top up is less than the limit.

Asset disposal (Collateral Foreclosure)...

2.18. The purpose of the asset disposal clause is to restrict the sale, lease, or disposal of the borrower's assets or business. Any disposal of collateral should be done when due process is followed, which include obtaining a writ of execution from the High Court.

3. WHAT TO LOOK OUT FOR IN A LOAN AGREEMENT

3.1. Borrowers should note that once signed, the loan agreement becomes binding and it is assumed that the borrower has read and understood the terms and conditions of the Loan Agreement.

3.2. It is therefore necessary for borrowers to take time to read and understand the terms and conditions of the Loan Agreement before signing and committing themselves.

3.3. Asking questions about anything that is not readily understood will help to avoid future misunderstandings.

3.4. In particular borrowers should be clear on the following:

- a. A breakdown of all the applicable charges;
- b. Whether the quoted interest rate is weekly, monthly, annually etc;
- c. Whether the interest is compounded or simple interest rate;
- d. Whether the interest rate is fixed or floating;
- e. Whether the other charges are once-off or continuous;
- f. The level of the default/penalty rate for late payments and non-payments;
- g. Whether there is a charge for early repayment of the loan and
- h. Whether the lender has a right to change the terms and conditions of the agreement including the interest rates.

3.5. Where there is an insurance charge the borrower has the right to have sight of the insurance policy.

3.6. It is within the borrower's right to request for a copy of the Loan Agreement and seek independent advice from any other person of their choice before signing the Loan Agreement.

3.7. In terms of the law, once the Loan Agreement has been signed the lender is required to provide the borrower with a copy of the signed loan agreement, which should include a Schedule of Repayments.

4. OVER-INDEBTEDNESS

- 4.1. A person is said to be over-indebted when their existing and expected resources are insufficient to meet their financial commitments without lowering their standard of living.
- 4.2. A microfinance customer is over-indebted if he/she is continuously struggling to meet repayment deadlines and has to make unduly high sacrifices related to their loan obligations.
- 4.3. Over-indebtedness pushes customers into poverty, accompanied by the material, psychological and sociological consequences of debt. It has the potential of putting financial institutions, their portfolio quality, and their institutional stability at risk.
- 4.4. The excessive accumulation of debts accompanied by households' liquidity constraints causes deterioration in households' social and economic well-being, thus leading in the short and medium term to social exclusion and poverty.

Signs of over-indebtedness...

- 4.5. The signs of over-indebtedness often reflect the following aspects:
 - a) making high repayments relative to income;
 - b) being in arrears;
 - c) continuous borrowing; and
 - d) when debt becomes a burden.

What causes over-indebtedness?

- a) Failure by the borrower to understand the terms and conditions of the loan before signing the Loan Agreement;
- b) Failure by the borrower to assess his/her capacity to repay the loan;
- c) Taking more than one loan at a time;
- d) Borrowing from several MFIs and other sources; and
- e) Non-disclosure of extent of indebtedness to other MFIs, banks, credit stores, and other sources, to enable the lender to assess capacity to repay.

- 4.6. Members of the public are advised to desist from the practices noted above which lead to over-indebtedness.
- 4.7. The Reserve Bank has noted a number of cases where microfinance borrowers seek assistance following inability to meet their loan repayments.
- 4.8. Borrowers should take note that in most cases the microfinance institution will charge a penalty rate once a borrower fails to make a payment and this will increase the level of payments that the borrower needs to make in the future.
- 4.4. Members of the public must avoid borrowing beyond their capacity to repay and once they have borrowed, they should accept responsibility for their actions.

5. DISPUTE RESOLUTION

- 5.1. Dispute resolution generally refers to one of several different processes used to resolve disputes between parties, including negotiation, mediation, arbitration and litigation. Dispute resolution is the process of resolving a dispute or a conflict by meeting at least some of each side's needs and addressing their interests.

Scenarios where a dispute may arise...

- 5.2. Disputes may arise in any of the following scenarios where:
 - a) parties have failed to fully understand their contractual obligations;
 - b) terms and conditions of a contract have been unilaterally changed or waived;
 - c) expectations are not clearly communicated and therefore not met;
 - d) one party has an upper bargaining power or has more financial strength;
 - e) there has been an unfair business practice;
 - f) there is dishonesty or lack of trust or confidence;
 - g) complaints raised internally are not resolved or there is failure to resolve with speed and efficiency;

- h) one party has been misled, treated unfairly or supplied with substandard or unsafe products or where a substandard service has been provided;
- i) in instances of maladministration or misrepresentation (whether deliberate or inadvertent); or
- j) there has been an illegal activity.

Dispute Resolution Mechanisms...

- 5.3. Dispute resolution and redress mechanisms fall under either the formal court system or the alternatives available which generally fall under the umbrella of alternative dispute resolution. However, as to which alternative the consumer chooses will be a factor of which options are known to the consumer and whether the consumer has the financial resources for the respective alternatives.
- 5.4. Dispute resolution mechanisms and access to redress differ for consumers depending on the nature of dispute being dealt with and whether or not redress is specifically captured in terms of a contractual undertaking.
- 5.5. While the court system generally works well for most types of consumer disputes, it does have some disadvantages particularly in the case of financial services. The disadvantages include the time, cost and complexity of initiating court process which may dissuade some consumers from standing up for their rights.
- 5.6. However, consumers often lack awareness of the different types of remedies available and give such reasons like “we didn’t know what to do”, “we didn’t know where to go”, “we didn’t know who to complain to”, “we didn’t think it would make a difference”, “couldn’t be bothered” or “it’s probably too expensive”.
- 5.7. Where court processes are involved, there is usually an ignorance of court procedures or the same seem too daunting a task.
- 5.8. The redresses available for dispute resolution to the consumer are summarised below:

Microfinance Institution’s Complaints Handling Procedures

- 5.9. The Reserve Bank requires every microfinance institution to have internal Complaints Handling Procedures which ensure that complaints are handled and resolved efficiently and effectively.
- 5.10. The microfinance institution is required to communicate to all customers the existence of the Complaints Handling Procedures.
- 5.11. Where a customer has a complaint against the microfinance institution, he/she should raise the complaint with the microfinance institution in terms of the Complaints Handling Procedures.
- 5.12. The Reserve Bank is available to assist in instances where the microfinance institution has failed to resolve the issue of concern in terms of the Complaints Handling Procedures.

Civil Remedies and Courts

- 5.13. The legal system provides a necessary structure for the resolution of many disputes. Further, many people want a lawyer when they become involved in a dispute, particularly if the dispute involves perceived legal rights, legal wrongdoing, or threat of legal action against them.
- 5.14. The most common form of judicial dispute resolution is litigation. Litigation is initiated when one party files a suit against another. The proceedings are very formal and are governed by rules, such as rules of evidence and procedure, which are established by the legislature.
- 5.15. Outcomes are decided by a magistrate or judge, based on the factual questions of the case and the application of law. The ruling of the court is binding, not advisory; however, both parties have the right to appeal the judgment to a higher court.
- 5.16. Actions may be brought by an aggrieved party either to the Magistrates Court or the High Court, depending on the amount in dispute. The Magistrate Court deals with litigations involving amounts below USD\$10,000 whilst the High Court deals with amounts above USD\$10,000.

Class Actions

- 5.17. There is also a procedure available for legal action to be filed by groups of private individuals who have each suffered a similar harm as a result of the actions of the same defendant. Collective action can be particularly useful in cases where large numbers of consumers have each suffered small losses.
- 5.18 It offers an avenue for redress to consumers who, due to the low value of their individual claims, would not be willing to undertake the burden and cost of legal action individually. The threat of collective action lawsuits can also play an important role in regulating the marketplace, depriving defendants of ill-gotten gains and deterring future wrongful or irresponsible commercial behaviour.

Alternative dispute resolution

- 5.19. There are also other methods of dispute resolution such as arbitration and mediation used to resolve conflict and potential conflict. These are commonly referred to as alternative dispute resolution.
- 5.20. Alternative dispute resolution generally depends on agreement by the parties to use alternative dispute resolution processes, either before or after a dispute has arisen.
6. For further information on the issues discussed in this Bulletin and general information on the Reserve Bank's regulatory and supervisory activities, members of the public may contact Bank Licensing, Supervision and Surveillance Division on the Reserve Bank numbers (04) 703 000.