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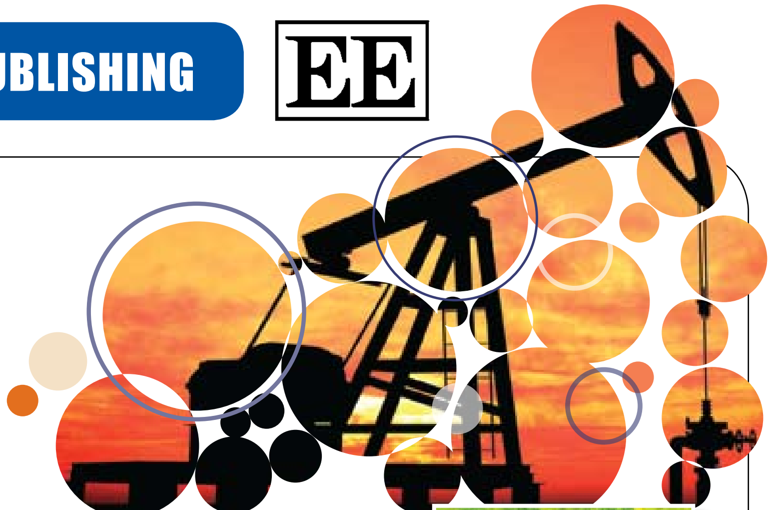
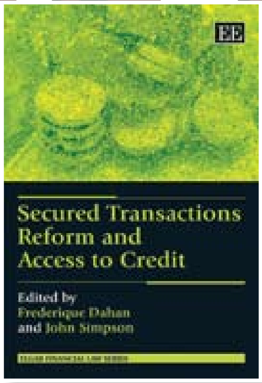


Secured Transactions Reform and Access to Credit

Edited by **Frederique Dahan** and **John Simpson** who have been working in the Office of the General Counsel at the European Bank for Reconstruction and Development over the last decade.



Secured transactions reform, also known as collateral or pledge law reform, is increasingly seen as an important building block for economic development. The commonly held view is that the availability and cost of credit, as well as the efficiency of the market for secured credit, are directly influenced by the laws affecting secured transactions and their implementation. However, there is still a lot of confusion about this relatively complex and technical area of the law and its role in promoting access to credit and economic growth. The chapters presented here provide, for the first time, a comprehensive and cutting-edge view of the subject – from both a legal and economic perspective. They start at the macro level of financial systems, moving towards the behaviours of lenders (commercial banks and micro-lenders), policy options for government and the mechanisms of collateral law reform.

By approaching the subject from different angles and experiences, the work advocates an inclusive approach to the subject where all stakeholders' interests can be taken into account. It addresses the question of what role laws and institutions can play to encourage access to credit. This book will be of primary interest to those involved in economic development and the interaction between law and economics, either for practical reasons (for example, working on reform or providing advice on investment in transition economies) or for research purposes.

Contents: Part I: Access to Credit and Collateral in a Global World Part II: Collateral Law to Support Access to Credit: A Case for Reform Part III: Taking Collateral in Practice: Microfinance and Mortgage Part IV: Stories of Reform: Lessons Learned and Remaining Challenges

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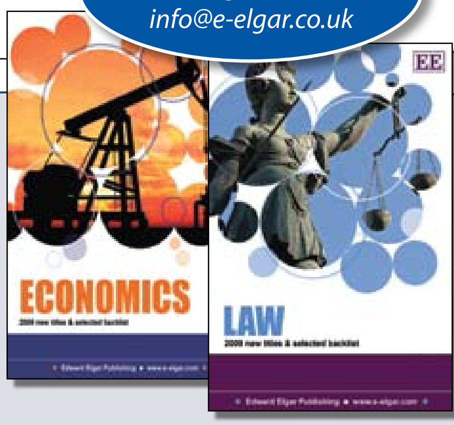

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11. Challenges in implementing secured transactions reform in Latin America

Nuria de la Peña*

The lack of an effective framework for secured transactions in Latin America substantially limits its economic growth, as has been well emphasized in the preceding chapters. Legal restrictions on the use of collateral, moreover, reinforce the inequality in the distribution of wealth. The laws and institutions that support the use of collateral work well only for owners of real estate who have clear title to their land. Wealthy landowners have better access to credit, enabling them to add more easily to their wealth. This defective system of collateral most hurts those who are already disadvantaged – indigenous people, women and the disabled – the groups most heavily represented among the landless and holders of untitled land.

A major problem is the lack of an effective framework for using movable property as collateral for loans. Only new motor vehicles and titled urban real estate are readily accepted as collateral. Yet new motor vehicles represent less than 0.5 percent of the capital stock. Micro, small and medium-size enterprises typically have 95 percent of their assets in movable property

* The arguments set out in this chapter were first presented at the International Conference on Collateral Reform and Access to Credit, London, August 2006, sponsored by the EBRD and the World Bank. The views expressed in this chapter are solely the author's and do not represent the views or opinions of CEAL or the governments, institutions or countries it represents.

The author thanks her associates Fernando Cantuarias, Heywood Fleisig, Alejandro Garro, Lance Girton, Peter Winship, John Spanogle and Roberto Muguillo, who have all so actively and enthusiastically participated in the CEAL programs on which this chapter draws. She thanks also CEAL's many local attorneys, who have so helpfully collaborated in uncovering the intricate problems of collateral. She is grateful to all those interviewed, who have so patiently given their time to explain their business practices and the many challenges they confront. Finally, she thanks the many chambers, associations and foundations in Latin America that have provided their invaluable support to secured transactions reform.

rather than real estate. Most small farmers have no urban real estate, but their equipment needs amount to about 80 percent of their investment.[1]

Those owning no real estate or lacking formal title to their land do have assets: their movable property and land use rights. Under advanced collateral systems, this property could serve as collateral, or they could purchase on credit equipment that could serve as collateral. Yet because of the defective legal system for using collateral, they cannot obtain such credit.

These problems restrict credit for all small and medium scale enterprises. However, in relative terms, they fall most heavily on the poor, the region's small farmers and businesspeople, precisely those whom most development programs and free trade agreements aim to reach. Their inability to use economically important property as collateral arises entirely from the legal system: it has no other roots, economic or noneconomic.[2]

11.1 CASE FOR REFORM: LIMITED ACCESS TO CREDIT

Since 1991, staff of the Center for the Economic Analysis of Law have conducted hundreds of interviews with lenders, farmers and businesses in Latin America for reports under programs of the World Bank, the Inter-American Development Bank and the US Agency for International Development (USAID).[3] In these interviews banks were questioned about the process of securing loans, including the terms and the types of collateral they required and the reasons that other types of collateral were not accepted. They were also asked questions about whether they were able to collect loans in default, how long it took and how much it cost. Merchants were asked similar questions about how they sold on credit. Farmers and businesses were asked about how they financed their operations, from whom and under what terms they had borrowed, what kind of collateral was accepted and their understanding of why other types of collateral were rejected.

The information gathered was then cross-checked with legal research on secured transactions laws in the country. In each case the limited access to credit reported in the interviews matched a limitation under pledge, mortgage, registry or other law relating to collateral.

The interviews also revealed many potentially profitable investment opportunities that went unexploited because the legal problems in using

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1 World Bank, Investment Climate Survey, world-wide, 2006.

2 de la Peña and Fleisig (2001).

3 Some of these reports are available on the website of the Center for the Economic Analysis of Law, www.ceal.org.

collateral broke the chain of credit. An equipment dealer in Uruguay for example had many clients to whom he was willing to sell on credit. But the dealer could not make such loans because he could not use his inventory and accounts receivable as collateral to obtain the additional financing he needed from a bank. While he had US$1 million dollars in farm equipment, his ability to borrow was confined to his capital in real estate, a small shed worth about US$30 000. Similarly, a flower exporter in Colombia had profitable export contracts, but could not finance the industrial refrigerators and other fixtures needed to better compete.[4]

Some of these problems can be seen in the examples throughout this chapter, which refers mainly to Latin American countries with a Civil Code tradition (excluding Brazil, Chile, Costa Rica, Panama, Paraguay and Venezuela, where no comprehensive research has been undertaken in this area). The chapter focuses primarily on movable collateral. To expand access to credit to its full potential, a secured transactions reform should also improve real estate collateral and the underlying system of property rights (see Simpson and Dahan, Chapter 8, this volume).[5]

11.1.1 Costlier and Riskier Financing of Accounts Receivable

One way in which legal restrictions limit access to credit in Latin America is through the ineffective laws available for using portfolios of accounts receivable and other small loans as collateral. Under advanced legal frameworks for secured transactions, lenders that make many small loans, and sellers and dealers that often sell on credit to small borrowers and farmers, can use such portfolios as collateral for further financing.[6] This can be done whether the loans or accounts in the portfolio are unsecured or secured with real estate or movable assets. Thus this secured transaction provides a crucial link in the chain of credit that links larger lenders to smaller borrowers; such as from banks and capital markets to microlenders, sellers and dealers and thence to individual borrowers and farmers.

Refinancing accounts receivable is simple under an advanced framework of secured transactions like those provided in Romania and Peru in their recent reforms (Figure11.1).[7] Such a system permits the original creditor to borrow by offering as collateral a floating security interest against a portfolio of its accounts receivable. The modern system gives the new lender

[4] Fleisig and de la Peña (1994); and de la Peña and Fleisig (2006).
[5] See de la Peña (2004).
[6] de la Peña, and Fleisig (1997b); and de la Peña et al. (1996).
[7] See de la Peña and Fleisig (2004); and the Peruvian law on security interests in movable property, Ley de la Garantía Mobiliaria of February 2006.

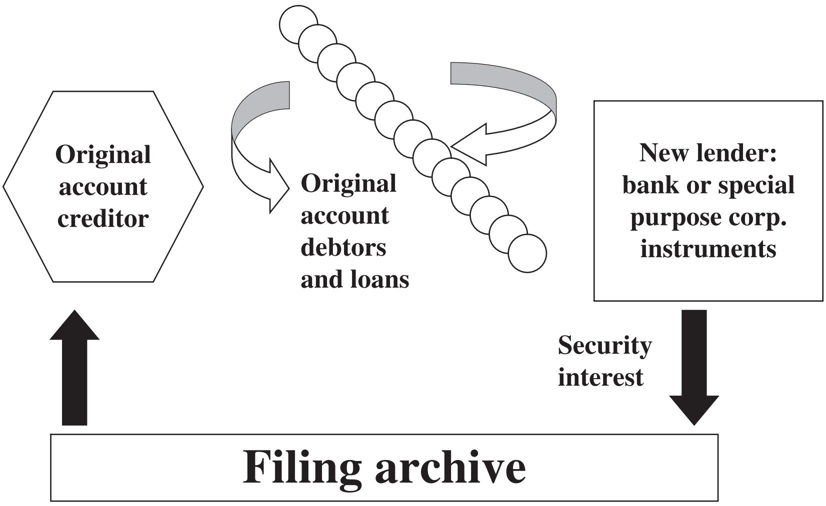

Figure 11.1 Accounts receivable financing under an advanced framework

clear priority in claims against the accounts receivable from the time the new lender files a notice of the security interest in a public archive or registry (without any requirement to notify the account debtors). This public filing gives the new lender priority relative to any assignees or pledgees and against the trustee in bankruptcy.

Moreover there is no need to transfer the accounts. They can stay with the original creditor and rotate, with the security interest 'floating' from the old ones that are paid off to new ones that automatically enter the pool. Unless there is a default, the account debtors continue their relationship with the original creditor. Because the original creditor is often better able to collect from them, the performance of the portfolio remains unaffected by the new financing.

In unreformed systems in Latin America the same transaction is both many times as expensive (in terms of fees) and many times as risky (Figure 11.2). To obtain financing against accounts receivable, the original creditor must transfer each account to the new lender. This system raises costs. Each assignment must identify a particular account or accounts, and in most Civil Code countries it involves paying the costs of a public notarial deed. Healthy businesses have a rotating portfolio of accounts receivable; old accounts are paid off as new accounts are generated. Under obsolete systems, as these old accounts are paid off, more assignments need to be made to transfer new accounts to the new lender. The accounts may rotate

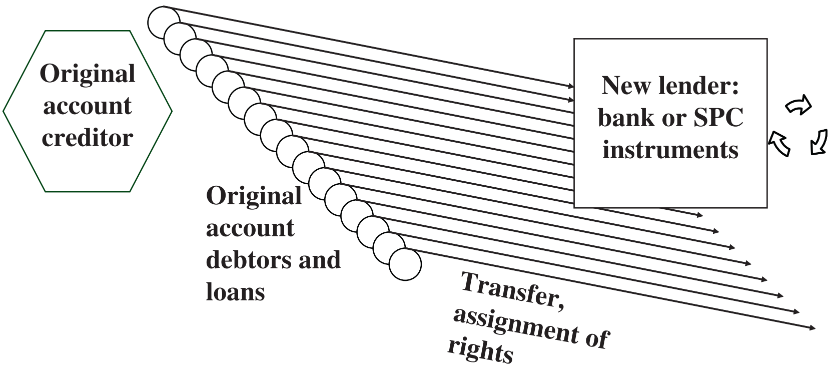

Figure 11.2 Accounts receivable financing in Latin American Civil Code countries

only afterwards, when the new lender issues shares, bonds or other instruments against its capital. Obsolete systems also increase risk. The new lender can establish priority only by giving notice of the assignment to each account debtor. Often, however, the new lender does not want to notify the account debtors because it may increase the risk of default. Such accounts are generated by debtors in transactions with local dealers with whom they have long-standing business relations that are costly to jeopardize. However, when the account is transferred to a new lender (perhaps a bank in the city) without such a relationship to the account debtor, the new lender may be less effective in collecting against them. The new lender could get around this by not notifying the account debtors of the transfer. However this merely changes the nature of the risk, since failure to inform the account debtors suspends any ranking of priority in the accounts.

Because of the riskiness of the transaction, efficient companies and lenders that expand their operations do not obtain additional financing using their portfolios of accounts receivable and small loans. One Colombian banker laughed when asked, saying accounts receivable were not collateral at all. In Colombia, for example, accounts receivable are often refinanced through an existing credit line secured with real estate. This financing does not expand as operators become more efficient and attain more accounts receivables. In Bolivia microfinance institutions often refinance their many small loans through an existing credit line guaranteed by the microfinance donors, no additional credit is given with the collateral of their portfolios of small loans. Many companies interviewed in Latin America were able to finance their operations only with their own savings.

When financing does not expand as operators become more efficient and acquire more assets, it limits their growth.

11.1.2 Higher Interest Rates

The limited access to credit in Latin America can also be seen in the interest rates that borrowers must pay, rates many times those in countries with advanced laws for secured transactions. The interest rates are higher even when country macroeconomic risk is taken into account.

In Bolivia, for example, the average interest rate charged on secured loans for new cars in 2005 was similar to that in the United States (Figure 11.3), with the small difference easily corresponding to the difference in macroeconomic risk between the two countries. For used cars, however, the average interest rate in Bolivia is considerably higher, far higher than in the United States. Why this difference? New car financing relies on the title transfer from manufacturer to buyer by the dealer and the state-certification and registration of that title. This supplements the secured transactions system. Used car loans lose the advantage of the chain of title back to the manufacturer and depend only on the state registration system of the pledge and the pledge regime for priority and enforcement, which are very weak. For loans secured by most other types of collateral, such as cattle, computers and equipment, there are no published data on loan terms or interests rates in Bolivia because there are no such loans.[8] Such loans are weaker than motor vehicle loans because they rely entirely on the legal framework for secured transactions, and have no support from the state-certified title and state registration system. Most lenders interviewed explained that they could not make such loans because the problems in the framework for secured transactions make these loans too risky.

11.1.3 Roadblock of Political Opposition

However powerful the case for reforming the secured transactions framework in Latin America, political opposition to such reform poses enormous challenges (see Fleisig, Chapter 3, this volume). In most countries reform of the framework for secured transactions has hit big roadblocks or made no progress at all.

Colombia and Nicaragua have active reform programs, but they face enormous political opposition from the legal community. After several efforts, programs in Argentina (a World Bank and Central Bank project)

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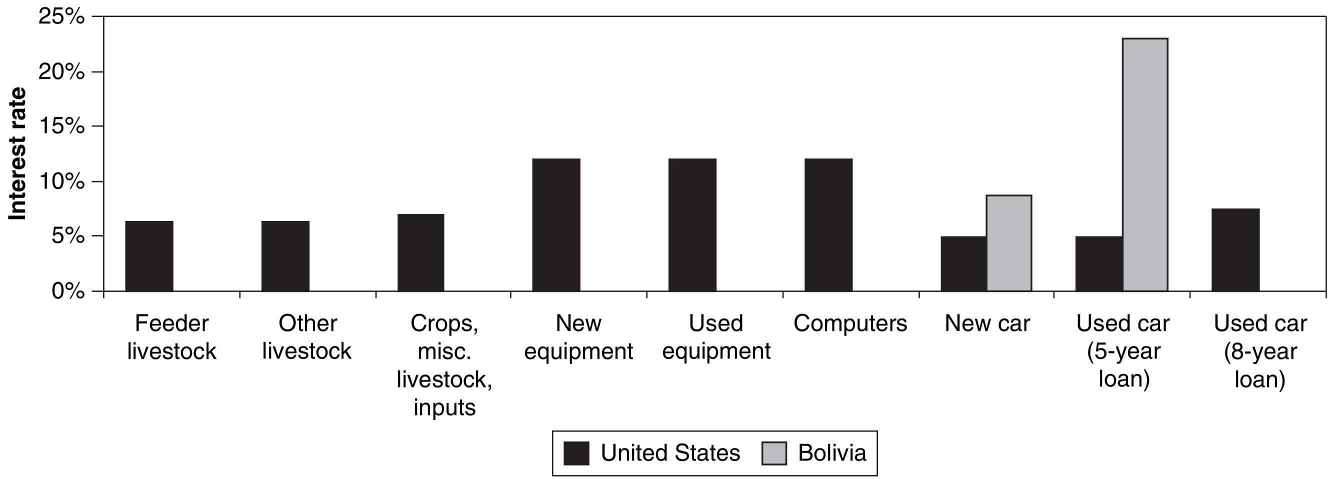
8 Fleisig (2006) p. 9.



Source: Fleising et al. (2006)

Figure 11.3 Average interest rate for loans secured by different collateral, United States and Bolivia, 2005 and Bolivia (USAID's PREMIER) appear to have been suspended or canceled. El Salvador, where reform faces strong opposition from the registrar's office, has rejected several project proposals. Mexico passed a new law on secured transactions in 2000,[9] but this law left almost every key aspect of the framework for secured transactions unreformed. The new law expanded creation of security interests, but continued the old internally inconsistent system of priority of claims in collateral, the poorly-run state registration system, and introduced a very limited reform for enforcing security interests. While Brazil, Chile, Costa Rica, Panama, Paraguay and Venezuela have not yet considered reform, though they show every evidence of having just as many problems in their secured transactions frameworks as the other Civil Code countries in Latin America, Peru is the only such country to have passed a comprehensive law on security interests in movable property in 2006.[10]

11.2 MAIN LEGAL RESTRICTIONS ON SECURED TRANSACTIONS

The legal roots of the economic problem lie in each of the four key stages of secured transactions: creation, priority, publicity (registries) and enforcement. To succeed, reform must address each of these stages. In all of them, however, reform is likely to encounter political opposition.

11.2.1 Creation

In Latin American Civil Code countries with unreformed systems of secured transactions, the law puts many restrictions on the creation of security interests. The law often not only restricts the types of property that can serve as collateral; it also may limit the types of agents that may enter into security agreements and the transactions that may be covered.

Parties that contract outside the law will find their security agreements unenforceable. A transaction outside the law might be used in a country for a while, but in times of economic distress it will soon be voided by the courts. Argentine jurisprudence, for example, provides many cases of pledges voided during the financial crises of the 1990s.[11]

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9 Mexico, *Ley General de Títulos y Operaciones de Crédito*, 23 May 2000.
10 Peru, Ley de la Garantía Mobiliaria Law No. 28677, 1 March 2006.
11 de la Peña and Fleisig (1997a).

Laws of limited application

Some leasing, trust and warehouse laws permit only government-licensed lenders to function as secured lenders or trustees. These laws have had, in the long term, a very detrimental effect in Latin America. They not only prohibit secured transactions by other lenders; they also have created interest groups that now have a monopolistic niche in the credit market. These lenders often oppose reform in secured transactions because it would open their privileged position to all lenders. For example, interest groups of leasing companies and trustee companies in Argentina and Colombia and warehouse operators in El Salvador either do not support secured transactions reform or directly oppose it.[12]

Limits on floating security interests

Laws in Latin American Civil Code countries also often limit floating security interests and security interests in future property. Where pledge provisions require that collateral be specifically identified or that the debtor own the collateral before entering into a security agreement, they limit the financing of inventory and future crop.

In Nicaragua for example one Sandinista farmer interviewed said, 'I did not know at the beginning of the season how many hectares of coffee and how many of beans I was going to harvest, but the bank wanted a detailed list and description of each crop because so the *prenda* [pledge] requires in our Civil Code'.

Opposition to provisions allowing floating and future security interests often comes from legal conservatives, who believe that such provisions are contrary to the Civil Code.[13] Yet there is in fact no conflict with the Civil Code. In Nicaragua for example the provisions in the Civil Code on conditional obligations and those that set priority from the time of publicity address the legal issues posed by floating and future collateral (see alslo Mathernova, Chapter 9 and Ancel, Chapter 12, this volume, for further examples).

High notary fees

Another challenge to reform arises when the law requires that notaries be involved in the legal processes for creating security interests. Sometimes the law requires that a security agreement be validated by a notary or drafted

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12 Views expressed to the author and her team during mission discussions on secured transactions reform.

13 See for example N. de la Peña, Memorandum to Claudia Aragón, Secretaría Técnica de la Presidencia, Nicaragua, re draft law discussion meeting with the Supreme Court, 26 November 2006.

as a public deed. And sometimes the Code of Civil Procedure allows the use of faster processes only with certification by a notary.

In some Latin American countries notaries' fees are high relative to the average income or to the value of the transaction. This is especially likely where a monopolistic regulatory framework allows notary associations to set the fees. When a reform proposes to remove notary requirements, therefore, the notaries put up powerful opposition.[14]

11.2.2 Priority

In most Latin American Civil Code countries the system for establishing priority among conflicting security interests and other claims in collateral remains fragmented, with different priority rules applying to different security devices. This inevitably leaves creditors uncertain about their priority ranking relative to other creditors.

The solution at first seems simple and straightforward: have one rule applying to all creditors, with the first to file a notice of a security interest in a public archive or registry being granted first priority. The reformed law would then need to be comprehensive, encompassing all security devices and possible claims in collateral. Also, it would contain some key public policy provisions to allow competition for additional financing, such as purchase money security interests, which should be given super-priority upon filing against the assets that such security interests finance.

Initially, most interest groups of lenders interviewed in Latin America fully agree with the first-to-file priority rule. As they look more closely at it, however, they oppose the public policy provisions that a 'first-priority rule' needs to foster competition (see below). A reform without these provisions will mean limited competition in the financial sector – a key reason for the limited access to credit for SMEs, small farmers, the poor and the landless in Latin America.

Resistance to competition from existing lending institutions

By most estimates private credit amounts to about 20–30 percent of GDP in Latin America, and banks account for as much as 90 percent of total private credit in most countries of the region. In countries with reformed systems of secured transactions, private credit amounts to as much as 220–300 percent of GDP, with banks accounting for about 40 percent of

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[14] See for example Association of Private Banks of Bolivia (Asociación de Bancos Privados de Bolivia) to Superintendence of Banks of Bolivia, Letter, 4 March 2005.

the total (see Fleising Chapter 3, this volume).[15] In reformed legal frameworks, therefore, the 'bank business' is many times as large, though it occupies a smaller share of the total credit market.

Nevertheless, interest groups of lenders in Latin America, such as banks and microfinance institutions in Bolivia, sometimes oppose legal provisions that would allow more intermediary lenders to enter the credit market. These existing lenders rarely focus on the fact that allowing more lenders can increase overall credit. Instead, they focus on the 90 percent of the credit market that they now have and that they would have to share with other lenders. Protecting what they have becomes their objective, and they often do anything to oppose the reform.

In Bolivia in 2005 for example banks[16] and microlenders[17] and local chambers of commerce[18] sent letters to Congress and the President opposing the reform. They raised many legal objections to reforming the country's pledge laws: common law versus civil law, incompatible systems, the possible security risks of an Internet registry, the constitutionality of creditor-administered enforcement and the like. After experts explained how all the legal issues could be resolved within the Bolivian legal system, the key issue that remained – the one that always remains – was a matter for political decision: whether to open competition in exchange for a much larger credit market.

How political opposition blocked beneficial reforms in Peru

Peru shows how effective political opposition can be in blocking beneficial provisions that would increase competition (see de la Peña 2001a). The Government of Peru did not have a secured transactions project that would provide them with international experts to develop their draft law. Instead, it commissioned a working party that worked on its own and modeled their law after the CEAL draft secured transactions law prepared for a project in El Salvaodor that was presented at the International Seminar on Secured Transactions in San Salvador in 2000. However, as the Peruvian working group adapted the model in preparing the final draft law, it removed precisely the provisions that would have opened competition. It is unclear why

15 See for example de la Peña and Fleisig (2006).

16 Letter, n.14 above.

17 Association of Financial Entities Specialized in Microcredit of Bolivia (Asociación de Entidades Financieras Especializadas en Microfinanzas) to S. Smith PREMIER USAID project, Letter, 30 March 2005 (available upon request).

18 Chamber of Industry, Commerce and Services of Santa Cruz (Cámara de Industria, Comercio y Servicios de Santa Cruz) to Bolivian Congress, Santa Cruz, Bolivia, Instituional Positions (Posiciones Institucionales), 22 April 2005 (available upon request).

they did this. Possibly, without supporting expert help, they did not understand the economic importance of these unfamiliar features; or, perhaps, they thought it was natural to defend the position of the dominant lenders; or, perhaps, they could not defend the public poliy reasons when these provisions were attacked by dominant lenders.

- *Superpriority of purchase money security interests*: this feature promotes financing for new equipment by permitting dealers that sell equipment on credit to retain priorirty against such equipment over any other existing claims;
- *provisions that void restrictive covenants against creating security interests of subsequent priority in the same collateral*: loan contracts in Peru often include clauses requiring full payment of the first loan when a subsequent loan is secured with the same collateral. Provisions that void such clauses are needed to allow for the maximum divisibility of collateral and thus free otherwise frozen capital;
- *provisions establishing the priority of security interests in fixtures (movables attached to real estate) over mortgages in that real estate*: such provisions eliminate the requirement that the owner of real estate consent to the creation of a security interest in movables that will attach to the property, and void any clauses to that effect. Therefore, they often free borrowers from having to take a mortgage on their real estate in order to purchase industrial equipment through financing advanced by a dealer.

Excluding these provisions in the Peruvian reform will limit the economic impact of the reform in expanding access to credit beyond bank borrowers. Of course, priority rules are about balancing various interests. Yet such balancing must aim at increasing the social gain from expanding access to credit. These provisions eliminated from the Peruvian reform would have opened opportunities for lending by dealers and small creditors, thus creating a more competitive credit market in Peru. Banks also would have gained: when intermediaries such as dealers can lend at lower risk, they provide loans that banks can profitably refinance. Nobody expects a bank in Peru to lend directly to a poor farmer. But a reform of the secured transactions framework should expect that banks will refinance the loan portfolios of nonbank intermediaries, such as dealers of agricultural inputs and equipment. In turn, these intermediaries bring financing to small farmers by selling to them on credit.

Therefore, the opposition by Peruvian banks to these provisions seems shortsighted. They would also have expanded access to credit by nonbank lenders, but they would also have expanded many times the overall credit that banks could extend. Thus, these provisions that were eliminated would have increased the economic impact of the reform by expanding access to credit. It would have also fostered a more equal distribution of credit, because nonbank lenders can better reach most of the poor as well as small and medium-scale businesses.

Protection for consumer, labor and tax claims

Another key challenge in reform arises from the priority granted to consumer, labor and tax claims relative to security interests. Whether to afford protection to such claims is a public policy decision. Whatever protection a country decides to provide to such claims, however, a reform needs to emphasize transparency of the protected claims. That permits lenders the essential ability to assess in advance the equity value of collateral while still allowing the public policy choice of giving priority to the protected claims.

The draft law integrates protected claims into the overall framework of claims against property while minimizing exceptions to the priority system of contractual security interests in the same property based on order of filing. It does this in different ways: in some cases, by setting out predetermined amounts for protected claims and easily veritifable statements of taxes due, so that secured lenders will know the size of claims having automatic higher priority. In other cases, it requires public filings of all possible claims or interests in collateral, including tax, labor and civil liability claims in order for a prospective secured lender to take account of these claims when evaluating the collateral being offered.

11.2.3 Publicity

In a first-to-file priority system the law must designate where to file security interests, so that any potential lender can quickly determine whether the collateral offered by the borrower is subject to prior security interests or other claims. Ideally for this purpose, that place would be a notice filing archive, based on the Internet. In a notice filing archive system, only a notice of the existence of a security interest is filed, offering important advantages in cost and accessibility (Figure 11.4).

All Latin American Civil Code countries that introduced a modern system use a first-to-file system to establish priority. However, their first-to-file systems fail to take advantage of the great simplification possible with a modern notice filing system. Instead, they inappropriately adopt many of the paper and manual filing features of the system for recording real estate (Figure 11.5). Such a registration system is many times more costly than a notice filing archive, for two main reasons.

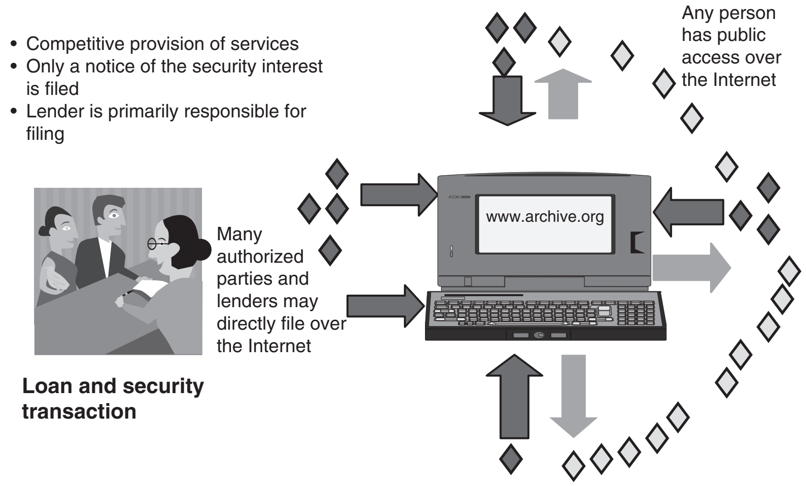
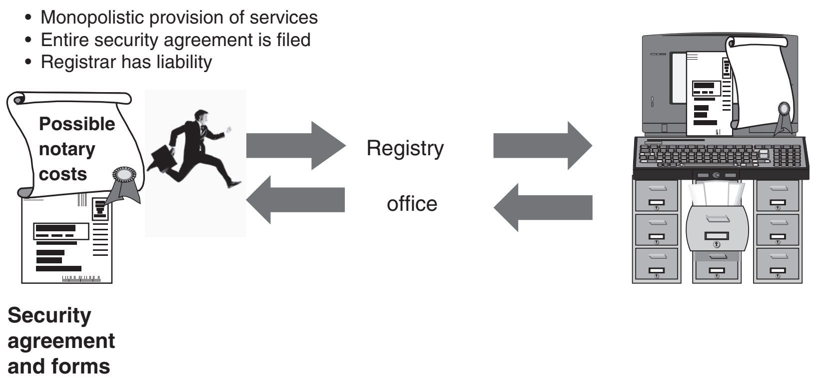


Figure 11.4 Notice filing archive for publicity



Note: Projects that introduce forms and computer systems at the registry offices do little to improve the publicity system if papers or paper forms still must be presented to the registry or scanned into the computer system. The ability to retrieve information is limited when access to the registry records continues to be permitted only through registry offices.

Figure 11.5 Registry for publicity

First, under the registration system in most Latin American Civil Code countries, the law requires the filing of the entire security agreement, not just a notice of its existence. As a result, the registry must store more information than is necessary, increasing its costs (for contrast see Lupulescu, Chapter 10, this volume). Computerizing a registry by itself does not help, because parties are still required to bring the paper security agreement or paper form to the registry.

Second, the law assigns the liability for recording correct information to the registry, not to the private lenders. This liability forces the registry to undertake costly legal functions to verify that the information in the security agreement conforms with the law before recording it. It also forces the registry to keep a paper or scanned copy of the security agreement for verification purposes.

Imposing these liabilities on the registry adds enormously to its operating costs. A registry system such as that in Colombia needs software, scanner equipment and substantial computer storage space. It needs many registry employees, including many lawyers, in several parts of the country to enter the data and verify information, along with the attendant payroll, office space and administrative expenses. Both initial and operating costs are very high.[19] Oddly, even though this responsibility is used to justify the higher costs of verification and record keeping, its economic value to users is unclear. No Latin American registry, to our knowledge, has ever taken financial responsibility for errors it committed in the registration process.

By contrast, notice filing systems, in which lenders are responsible for the information filed and often also make filings directly into the archive, operate at a much lower cost. A notice filing system with these characteristics, serving an entire country with a population of about 25 million would cost about US$50 000–100 000 to set up, with operating expenses of US$150 a month for rented Internet server space and staff costs for about three government employees for supervision. All other costs, for data entry, legal review and verification, are borne by the lenders as part of their work to process a loan. The public can freely access the archive at no cost from any computer with a Web browser.[20]

Access to a registry system is also often more limited than to a notice filing system. The requirement to file the entire security agreement results in too much information in the registry, raising issues of privacy for the parties involved and raising concerns about providing full public access. No such concerns exist with a notice filing archive, and lenders can easily search for prior claims in collateral.

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19 See de la Peña and Fleisig (2006).

20 Romania for example has implemented a public Internet-based archive under a notice filing system (see de la Peña and Fleisig 2004). The model for this archive is being followed in the secured transactions reform program of the government of Nicaragua. It is available at www.ceal.org.

Most registry systems in Latin America are run by the government. But even when they are run by the private sector, they do not permit competition in the services they provide. So there is effectively no incentive for providing good registry filing services. By contrast, in the most advanced notice filing systems, competition is introduced when the law authorizes lenders and other persons to file security interests directly in the archive. Competition is opened both for filing services and for searches of the archive through its Internet site (see Lupulescu, Chapter 10, this volume).

Finally, registry systems in Latin America present common 'registry problems', which can increase risks for lenders. There can be errors in receiving and archiving paper, and paper-based searches are less likely to be accurate than a computer search of a notice filing database. Moreover, they often establish priority by the date of filing rather than by the date and time (hour, minute and second), opening possibilities for conflicts in priority.

With all the drawbacks of registry systems, who would oppose switching to a competitive Internet archive and notice filing system? All those who gain from the inefficiencies of a registry system: the registry employees, the politicians who award them the jobs, the courts that depend on the registry fees, the lawyers preparing the complex filings.[21]

Meanwhile, these expensive publicity systems have their most detrimental impact on small loans and on the refinancing of large numbers of small loans, both secured and unsecured. This limits the success of a secured transactions reform in expanding access to credit to small and medium-size enterprises and the poor.

11.2.4 Enforcement

Enforcement of secured loan contracts in Latin American Civil Code countries remains a long, expensive and risky process, limiting the economic value of collateral.[22] Even Mexico and Peru, which have undertaken secured transactions reform, have yet to address enforcement problems. Mexico provides for a quick out-of-court sale, but the new law left repossession unreformed. Peru provides for notary repossession rather than privately-administered ('self-help') repossession.

The high costs of enforcement in Latin America stem from fees charged by lawyers, notaries, the courts and judicial officials as well as

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21 See for example and Chamber of Industry, Commerce and Services of Santa Cruz (Cámara de Industria, Comercio y Servicios de Santa Cruz) to Santa Cruz (Cámara de Industria, Comercio y Servicios de Santa Cruz) to S. Smith PREMIER USAID project, Letter, 25 June 2005 (available upon request).

22 See de la Peña, and Fleisig (2001).

from the time required to complete repossession and sale. The long delays also increase risks for lenders. In rural areas lenders may face even higher costs and risks because of lack of availability of the enforcement mechanisms provided by law (for example lack of access to courts or notary services where the law requires court or notarial enforcement).

Legal and judicial interest groups are often strongly opposed to reforming enforcement systems. They particularly oppose extending enforcement rights to creditors and permitting creditor-administered repossession and sale of collateral. They often justify their opposition by arguing that out-of-court enforcement is unconstitutional in their country.[23] Legal research by many reform programs has shown that constitutional arguments do exist that favor creditor-administered repossession and sale of collateral over due process clauses in the constitution.[24] Yet legal and judicial groups often cling to their unconstitutional arguments in opposing the reform.

An enforcement system that is expensive may still support bank lending and large or medium-size loans. But it will limit lending by microlenders, dealers and other non-bank lenders, which can often reach farmers and poor people more effectively and efficiently.

11.3 STATUS OF THE REFORMS – AND HOW TO MOVE FORWARD

The gap between incomes in Latin America and the high income OECD countries is widening.[25] At the same time that Latin America falls behind in its development efforts, it barely makes progress in reducing poverty. Between 1990 and 2003, LAC reduced its incidence of extreme poverty by less than any other region except sub-Saharan Africa.[26] The limits on the use of collateral, which have kept private credit at about 20–30 percent of GDP in most Latin American countries, remain a major constraint to economic growth.

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23 See for example Letters, n.14 above and Memorandum, n.13 above.

24 See for example de la Peña and Fleisig (2006), Annex I: Constitutional Law Issues by Marcel Tangarife.

25 Income per capita in Latin America was 13.9% that of the high-income OECD countries in, 2000 but only 10.9% of that income in 2005 (World Bank, 'Key development data and statistics', available at www.worldbank.org.

26 The incidence of extreme poverty (population living on less than US$1 per day) fell 19% in Latin America between 1990 and 2003. It fell by more in all other regions except sub-Saharan Africa (+1%) and Eastern Europe and Central Asia (+280%). World Bank (2006) Table 2.3, p. 60 available at www.worldbank.org.

Despite these high stakes, the approaches to reforming secured financing in Latin America remain unsuccessful. There have been limited reforms to the pledge and accounts receivable laws in Argentina, Uruguay and Honduras. The pledge, however, is such a restrictive security device in Latin America's Civil Codes, and it has been so restrictively applied by the courts for so many years, that it remains a very ineffective device for expanding secured lending.

Factoring laws to address accounts receivable financing have also had a limited impact, because the reforms have retained a system of transfer of the loan portfolios (see Figure 11.2 above). Laws for the securitization of mortgages have suffered the same legal problems as those for accounts receivable, as they include only a system of securitization with transfer. In addition, securitization laws in Latin America have not resolved the secured transactions problems in the underlying original mortgages. Therefore, these securitization reform programs have led to more financing mainly for those that already had mortgage credit, without expanding mortgage financing to the poor (see Simpson and Dahan, Chapter 8, this volume).

On the most advanced end of the spectrum, the reform in Mexico included some features of an advanced secured financing system. It did not include a comprehensive system of priority, however, nor did it resolve all priority conflicts among lenders. At the same time the reform retained the unworkable registration system. And its enforcement provisions left repossession untouched. These are key economic stages of secured transactions, and all remain unreformed in Mexico.[27]

Peru has a more advanced secured transactions law. Yet as noted, the provisions which would have allowed more competition from nonbank creditors were removed. Peru's filing system is still under construction, and meanwhile old models are in use. In addition, provisions for repossession of collateral introduced a notary requirement.

Why such spotty reforms? What have been the key obstacles?

11.3.1 Key Obstacles to Reform

Obstacles to this reform interact in a complex way, including elements of narrow self interest,[28] ignorance of law,[29] ignorance of the economic

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[27] For a discussion of the problems in Mexico before the reform, see de la Peña, (1996).

[28] See for example Institutional Position, n. 21 above, para. 8–11.

[29] See for example Chamber of Commerce of Quito, Ecuador (Cámara de Comercio de Quito) to Superintendent of Banks of Ecuador, Letter (email), 18 February 2005) (available upon request).

consequences of law[30] and a broad diffused support that seldom leads to local action.

Donor agencies and international development institutions and governments in the country lack the technical expertise to effectively join the debate. Local private sector interest groups in the region often have a better understanding of the issues. But their support is diffused across many sectors, making it difficult to reach common agreement. Moreover, this support is not consistent and is often countered by the opposition of lawyers and other powerful interest groups. Sometimes this opposition stems from benefits from the state and private monopolistic frameworks provided under the existing laws and sometimes from ignorance (see similar problems raised in Dahan and Simpson, Chapter 5, and an example of successful reform in Mathernova, Chapter 9, this volume).

With some limited and important exceptions, the judicial powers in the region have most aggressively opposed the reform. The legal and judicial groups of the region rarely see the links between legislation and economic outcomes. Lawyers and justices often are not used to considering the overall transaction costs of expensive legal processes that have no clear public policy justification, or acknowledging the impact that small legal requirements can have on small and medium-size enterprises and the poor.[31]

The executive and Congress have been most supportive of reform in some countries. Yet the conflicting positions they hear from their constituencies leave them paralyzed to act. In Bolivia for example Congress gets no support for the reform from banks and the local chambers of commerce.[32] Bolivian banks and microlenders oppose the reform because it would bring other lenders into the credit market.[33] The chambers of commerce are reluctant to improve registration because it would mean sharing their monopoly in processing registrations of commercial pledges.[34] Ironically, the President of the Bolivian Supreme Court and some of its justices support a new law on secured transactions – an exception worth noting given the opposition of other courts in the region.

The Organization of American States' (OAS) model law on secured transactions and the USAID Commercial, Legal and Institutional Reform project represent promising regional efforts. So does the legislative guide on secured transactions developed by the United Nations Commission on International Trade Law (UNCITRAL). But models always need to

30 Ibid.
31 See for example Memorandum, n.13 above.
32 Letter, n.14 above Institutional Position, n. 21 above and letter, n. 21 above.
33 Letter, n.17 above, para. 7.
34 Institutional Position, n. 21 above, para. 8-11.

develop general principles so that they can accommodate variations in each country. Moreover, they often need to sacrifice many best practices in favor of reaching common ground. As a result, regional models often have limited economic impact because they are unable to include the key legal features needed, particularly new provisions, revisions and derogations relating to publicity, enforcement and competition. The OAS model law on secured transactions for example recommends a troublesome registration system as represented in Figure 11.5.[35] So it may be better to rely on regional models in Latin America only in regard to their best features and for creating public awareness of the need for reform rather than for generating effective reform within a country.

International conventions (such as the UNCITRAL convention on receivables financing and the Convention on International Interests in Mobile Equipment (Cape Town, 2001) under the International Institute for the Unification of Private Law (UNIDROIT)) can lead to reform of local laws, if a country adopts them. But these conventions are too limited in application to achieve much economic impact in a country; some of these assets would represent less than 5 percent of the capital stock in the country.

Best international and regional alternatives would include model laws, principles and standards developed by institutions that rely mostly on expertise, rather than on the agreement of various jurisdictions, and that use economic analysis, such as the standards, indicators and benchmarks of the Legal Matrix of the Alliance for the Accountability of Property Rights[36] presented at the Summit of the Americas in 2005 and the EBRD Model Law on Secured Transactions.[37] Another route is to adopt international conventions that have a strong participation of leading business communities (for example the UNIDROIT convention), which may compensate for the lack of economic analysis of many instruments, and rely on them as models for domestic law with an expanded scope of application.

11.3.2 Project Design

In the coming years the key challenge in the reform of secured transactions is to design reform projects that draw on adequate expertise and pay adequate attention to political opposition. Past reform programs ignored political opposition. Some programs proposed rapid execution, drew on little technical expertise and included no resources for ensuring broad legal

[35] *Ley modelo interamericana sobre garantías mobiliarias*, arts. 35 – 46.
[36] Available at www.landnetamericas.org.
[37] Available at www.ebrd.com.

participation and promoting broad public awareness. While it may be possible to do the technical work in a short period, activities to address political opposition require much longer time frames and considerable expertise. It is unreasonable to expect the local legal community to reason its way independently through the principles of complex laws from the industrial countries that have included contributions from hundreds of lawyers over more than 50 years.

Of critical importance in project design is to draw on expert support in drafting legislation so that it addresses key economic details of reform. When the drafting process involves no input from economists, new legislation often leaves out many of these details. Moreover data on the potential economic gains from the reform are necessary to gain political support.

Incorporating economic indicators of success into reform programs can also be useful. Focusing on economic outcomes can provide flexibility in legal drafting. Whether civil or common law sources are used, the ultimate focus of reform programs should be on meeting certain economic targets in creation, priority, publicity and enforcement. By contrast, legal programs that present reform as consisting merely of having passed a secured transactions law may give a false impression of success. (see Fleisig, Chapter 3 and Dahan and Simpson, Chapter 5, this volume).

Government political action could focus on two fronts: on one front, setting up a government program on secured transactions reform that is comprehensive and that allows for the required time and expertise; and on a parallel front, governments and IFIs could link their credit lines to disburse for new instruments using the new legal devices.

Donors and international development institutions (such as USAID, the Millennium Challenge Corporation, the World Bank and its International Finance Corporation, and the Inter-American Development Bank and its International Investment Corporation and Multilateral Investment Fund) continue to play a key role in helping governments develop reform programs in secured transactions. These institutions could link the benefits of secured lending with their programs in advancing health, the environment, infrastructure, private sector development and banking or rural finance or in providing private project financing. For example they could address the problems in financing medical equipment, environment-friendly technology and future crops. Such sector programs could manage full reform activities or undertake diagnostics and produce indicators of the economic effects of restrictions on secured lending.

Latin America will simply not grow unless it improves its secured transactions frameworks so as to expand access to credit to permit exploiting high-return investment opportunities. Donors and international development institutions can help make the case for such reform through explaining and developing programs around links between secured financing and the economic problems in the region. Some of those links lead to specific benefits, such as in the way financing medical equipment can improve health. Others lead to broad economic gains, such as in the way secured lending can promote private sector development, help realize the benefits of free trade and lower risk for the financial sector by allowing diversified loan portfolios and opening financing by nonbank lenders – and in the way the ability to use movable property as collateral can expand access to credit for the poor and landless and produce a more equal distribution of wealth.

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