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Microenterprises and Collateral

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Different Access to Credit

It is no surprise that microenterprises get credit at worse terms than do large firms. They pay higher interest rates, get smaller loans relative to cash flow or income, and must repay their loans more quickly. Latin American microenterprises, however, pay much more for their small size than do their North American competitors..

Higher Interest Rates

In **Latin America**, a well-known and respected microlender charges 28% on solidarity group loans, about 15 (hwfcheck) percentage points higher than the 12.9% prime rate charged to the best large borrowers by commercial banks in the same country.[1]

In the **United States**, microenterprises[2] were paying 6% to 13% for business loans, 1 to 8 percentage points more than the prime rate of about 4.75%[3] charged to the best large borrowers by commercial banks. For all commercial and industrial loans made by the US banking system, the rate of interest for loans under $100,000 was 5.79% while the rate of interest for loans over $10,000,000 was 3.08%. Small loans cost, on average, less than 3% more than large loans..[4]

Smaller Loans

Moreover, the typical Latin American microenterprise gets far less credit at those higher interest rates: compared to North American microenterprises, those in Latin American get, on average, 1/10 the credit relative to cash flow.

What Explains the Difference In Lending Terms?

A Latin American microenterprises pays about 15 percentage points more than a large Latin American firm. A North American microenterprise pays on average about 3 percentage points more than a large North American firm. Compared to a large enterprise, why does the Latin American microenterprise have so much worse access to credit than its North American counterpart?

Country Risk and High Intermediation Spreads

The risk of devaluation, default, and capital controls as well as inefficiencies in financial markets and differences in reserve requirements combine to explain part of the differences in interest rates. These factors might explain why a prime borrower in the United States pays 4.75 percent while a prime borrower in Latin America pays 12.9%.

However, Latin American microenterprises pay 28% while North American microenterprises are paying an average of 5.8%. That is a difference of 22 percentage points. Country risk and high intermediation

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spreads could explain no more than 8 percentage points – about a third of the extra cost facing Latin American microenterprises.

Collateral and Lower Interest Rates

Most of the difference in credit terms between large and small borrowers in Latin America arises entirely from the inability to realize the economic benefits of collateral: either directly, in secured lending, or indirectly, as a method of refinancing unsecured loans.. These differences in terms have little to do with country risk or financial intermediation. Rather, they arise entirely from differences in the laws that govern the use of property as collateral or security for a loan – the legal framework for secured transactions.

Private lenders only lend when they think they will be repaid. Over the years, credit markets have developed two successful lending systems: unsecured lending and secured lending. Unsecured lending relies on borrower reputation and the lender's assessment of the borrower's future demand for access to credit. Secured lending relies on the lender's ability to seize and sell property to satisfy an unpaid loan. Both systems reflect sound economic logic and both attempt to address the main features of credit markets: adverse selection, moral hazard, asymmetric information, and uninsurable risk.

The presence of a good legal framework for collateral explains why small businesses in North America can borrow at terms close to those of large businesses. US microenterprises can usually get credit on the following terms. For unsecured loans, for borrowers who offer no collateral and do not own real estate, micro-enterprises can borrow an amount that equals about 50% of their income, pay an interest rate about 8 percentage points above prime, and take two to four years to repay. Microenterprises that offer movable property as collateral can get better terms. Even though they do not own real estate, they can borrow an amount equal to about one year's income, pay an interest rates 2 - 3 percentage points above the prime rate, and take four to six years to repay. If their cash flow permits servicing, they could borrow an amount equal to 75%-100% of this collateral. Microenterprises that can offer real estate as collateral – the house of the owner or the shop – can get even better credit terms: they can borrow an amount equal to three or four times annual income, pay interest rates that are 1 percent-age point above the prime rate, and take 15 to 30 years to repay. They can borrow an amount equal to 80% to 95% of the collateral.

Latin American microlenders respond in the same way to the framework for collateral. At the same time that a well-known microlender was charging 28% for solidarity group loans with a $3000 upper limit and 5 years to repay, it was offering much better terms for secured loans. It was charging 20.4% for loans up to $30,000 with five years to repay when the borrower offered a car as collateral. It was charging 18% for first mortgages on real estate in amounts up to $100,000 and offering 10 years to repay.[5] That is, it offered 10-30 times more credit at about 2/3 the unsecured interest rate when the borrower offered collateral.

The power of collateral works in both North American and Latin America. Better collateral produces lower interest rates, longer periods to repay, and larger loans relative to income or cash flow. The problem that arises for Latin American microenterprises, as we shall see, is that Latin American law does not permit much of their property to serve as collateral.. This limits microenterprise access to secured credit and raises the cost of both their secured and their unsecured credit.

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Collateral: What can Microenterprises Offer?

Lenders want collateral -- property that they can seize and sell if the borrower does not pay. What can micro-enterprises offer? Most microenterprises operate businesses where movable property comprises most of the capital stock and assets of the firm. Wholesale and retail merchants, for example, invest mainly in inventory and display cases. Construction companies have generators, trucks, power tools, and inven-tories of supplies. Artisans have inventories of input materials and completed product. Restaurant operators have cooking and refri-geration equipment and restaurant furnishings. Most have some office equipment. All them have as assets their “accounts receivable” – the funds they expect to be paid from past sales.

In addition, such businesses often want to buy this equipment on credit from a dealer or wholesaler. Acquisition of this equipment is often central to business development, expansion, and growth.

Typically, such businesses operate in rented quarters. If they do not own this real estate, they cannot offer it as collateral. Even where a microenterprise might own real estate, its business strategy and demand for credit will typically require the financing of additional movable capital relative to that fixed capital. Therefore, microenterprises usually can only offer movable property as collateral or attempt to buy this equipment or inventory on credit using the equipment itself as collateral.

But private Latin American lenders will typically not take movable property as collateral. Nor will private Latin American equipment dealers sell equipment on credit while using the equipment alone as collateral for the loan. Sometimes exceptions are made for those who demonstrate that they own real estate, but there is no systematic pattern.

The Secured Transactions Legal Framework: Secured Lending

Several elements of the Latin American legal framework for secured lending combine to make the property of microenterprises useless as collateral.

. First, the law does not provide an easy or inexpensive method of *creation* for such a security agreement. Instead, gaps in coverage exclude some lenders, some borrowers, and some property. The law does not give clear and unambiguous ranking of *priority* to lenders, making even otherwise valuable property worthless to lenders as collateral. Primitive registries limit *publicity* of security interests, making the practical determination of lender priority difficult or impossible. Finally, *enforcement* is slow and expensive. *Repossession* can take two or three years; lenders know this length of time far exceeds the economic life of much movable property that microenterprises can offer as collateral. Once repossessed, *sale* of collateral often requires complex, judicially-mandated procedures that ultimately put most of the proceeds of a sale into the hands of the auctioneer, appraiser, participating lawyers and officers of the court. By these features, Latin American law makes the otherwise valuable capital stock of the microenterprise useless to lenders as collateral.

For those fortunate few microenterprises whose operators own real estate, existing Latin American legal frameworks present further difficulties. Latin American security devices for real estate do not go beyond the mortgage. The mortgage is an expensive security device. Its costs of creation can represent a large fraction of the value of small properties and make the total cost of funds borrowed on a mortgage prohibitive. Virtually all Latin American mortgage procedures require that land be titled. However, much Latin American land is not

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titled, even though the occupants have legal rights to the title. Therefore, the occupant/ owner cannot mortgage that property. Other security devices that may use untitled or future titled land would serve Latin America better. However, these have not been developed under the legal system.

All the property described above would be acceptable as collateral to formal sector lenders in the United States. What prevents Latin American formal sector lenders from taking collateral in the same way? The answer is simple: while the figure of the existing Latin American law might permit it, the economic operation of the law does not. It does not matter if the law provides that a farmer can pledge a tractor if, at the same time, the law specifies a procedure for the pledge that actually does not permit the lender to recover any of the value of the tractor if the farmer defaults. The result? The valuable capital stock of US microenterprises serves as collateral and supports microenterprise access to credit. The valuable capital stock of Latin American microenterprises does not.

The Secured Transactions Legal Framework: Unsecured Lending

Unsecured lending is the only true substitute for collateral. Latin America has made enormous progress in advancing unsecured lending. An innovative range of ideas pressed forward by those lending to microenterprises has expanded access to credit enormously.

However, while unsecured lending can substitute for collateral, it cannot substitute for a legal framework for secured lending. To the contrary, unsecured lending in Latin America would benefit greatly from a reform of the framework for secured lending.

An unsecured loan is, itself, another piece of movable property. In a reformed framework for secured lending, a portfolio of such loans could serve as collateral for a refinancing loan. Were such an operation possible under Latin American law, sound microlenders could tap outside sources of funds at commercial rates. They could lower their costs and greatly expand their operations.

This is not a dream. American Express in the United States, to take one such lender among many in that country, extends credit to thousands of small borrowers daily. It has no deposit-taking bank to refinance these loans. Rather, it routinely finances its operations by taking commercial paper to private lenders – banks or capital markets. This commercial paper is secured by its portfolios of thousands of small unsecured loans.

Why can't Latin American microlenders do this? Because the legal frameworks for secured transactions in virtually all Latin American counties do not permit taking security interests in such portfolios of unsecured loans in a safe and inexpensive way.

Nor is it only microlenders who suffer from this legal problem. Dealers and suppliers can also provide important amounts of credit to microenterprise. Dealers routinely supply 30 days working capital in the form of sales of merchandise with 30 days to pay. These sales documents are themselves movable property. Dealers in the United States, can use their portfolio of accounts receivables arising from these sales as collateral for a loan from a formal sector lender. In this way, they can refinance these extensions of credit. Moreover, since they pay rates of interest somewhere between prime and the mortgage lending rate, on these refinancing loan, they compete and become important sources of funds for the enterprises they supply. As a result, extending credit becomes an important merchandising tool for the dealer and a profitable way to avoid the charges of credit card companies.

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Dealers in Latin America, however, have no such opportunities. While lawyers may assert that the legal device exists, there is in fact no legal feature that permits simple, cheap and safe financing that uses accounts receivable as collateral. This promising channel of credit to microenterprises is choked off, therefore, by the credit constraints facing the dealers themselves

What Does Reform Require?

Reforming the law of secured transactions, as a technical matter, has a few key ingredients. A new law must be written that satisfies the economic requirements of a modern financial system. The registry must be reformed to conform to the reformed law. Assuming the registry is replaced by a modern Internet based filing archive, the entire reform costs less than $500,000. Were real estate included in the reform, advisable from a technical and financial point of view for Latin America, the entire reform would still cost less than $750,000. While these may seem like large numbers to some readers, they are rounding error on the programs of the IFIs and large donors. Of course, the cost of this reform is even more insignificant in comparison to the oceans of defaulted loans made by public and publicly-guaranteed institutions who lent public funds despite the absence of a framework for secured transactions.

The Reform Record

Unfortunately, we can easily summarize Latin America's record in the reform of secured transactions: no country in Latin America has passed an economically effective secured transactions law.

Bolivia, for example, received about ten years ago a World Bank study detailing the links between problems in its legal framework for secured transactions and limits to access to credit.[6] That report explained how, as a result of Bolivian law, private lenders found no movable property economically useful as collateral; how Bolivian law deprived Bolivian borrowers of the benefits they could enjoy using their property as collateral. Instead, the report continued, most formal sector private lenders simply refused loans to clients who had only movable property as collateral. Other lenders frequently used the post-dated check as a guarantee; this device permitted them to imprison non-paying debtors. The paper surveyed jail inmates in La Paz and showed that 25% of the inmates were in jail for debt default.

Despite all this, the donor-supported draft law of secured transactions, submitted to Congress nearly six years ago, remains unpassed. Moreover, in its present form, weakened from amendment and redrafting, it will make little economic difference if it is passed. Private lenders in Bolivia, including many microlenders, continue to use the post-dated check as a guarantee and continue to threaten their non-paying clients with jail..

Reform efforts in other Latin American countries have not fared better. Though most of Latin America long ago abandoned imprisonment for debt, few countries have passed new laws of secured transactions. And where they have passed such laws, they have stripped them of their economically effective features.

Reform of secured transactions has not been enforced as a condition on any Latin American adjustment lending operation of the World Bank, Inter-American Development Bank, or the International Monetary Fund. Usually, it has not been a loan condition at all. Some IFIs, as a policy, do not link lending operations to legal reforms because the uncertainty of legal reform might impede disbursement of the loan. This strategy obviously limits their possible role in legal reform.

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Reform Prospects

Prospects for reform may be better than past performance. The G-7, G-10 and G-22 Finance ministers have signed statements exhorting the finance ministers of developing countries to support the reform of secured transactions. These statements further instruct the IFIs to support and promote these efforts.[17]

IFI and donor support for secured transactions reform appears to have been increasing. Their financial market operations now often include some support for inputs to the reform of secured transactions: studies, draft laws, computerization of registries. Much of this support, unfortunately, focuses on inputs to the reform process and not on the desired output – a comprehensive legal reform that has the economic effect of improving access to credit. This "input" approach may help lawyers and consulting firms but it has done little to improve access to credit for Latin American microenterprises.

Both the IADB and the World Bank have recently begun considering extensive and detailed studies of the failings in secured transactions systems. For the BID, this effort will cover Latin America; for the IBRD it will cover Latin America and the rest of the world. If these studies bear fruit, reform efforts may come to have a more clear focus on results.

Let us hope they do. For a variety of technological and market reasons, micro-enterprises in industrial countries have been expanding rapidly. For Latin America, these promising trends can best support growth and fight poverty if they are adequately funded. Adequate microenterprise funding requires private funding. Private funding requires a modern legal framework for debtor-creditor relations in general and for secured lending in particular. When it comes to passing laws, only the government can act. The sooner Latin American governments do, the sooner Latin American microenterprises can get this funding.

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[1] Interest rates taken from the website of BancoSol in Bolivia (www.bancosol.com); commercial bank prime rate from Banco Central de Bolivia, ***TABLA DE COTIZACIONES***, http://www.bcb.gov.bo.
[2] Microenterprises have a large presence in the United States. Of about 21 million firms in the United States, about 94% employed 9 or fewer workers. These smaller firms accounted for about 13% of total firm sales, 12% of total employment, and 10% of total payroll. (Source: Office of Advocacy, U.S. Small Business Administration, based on data provided by the U.S. Department of Commerce, Bureau of Census, Statistics of U.S. Businesses.)
[3] Federal Reserve ***Statistical Release H.15***, "Selected Interest Rates", August 2002
[4] Federal Reserve ***Statistical Release E.2***, "Survey of Terms of Business Lending, August 5-9, 2002, September 20, 2002
[5] Data taken from the website of BancoSol, Bolivia (www.bancosol.com).
[6] ***How Legal Restrictions on Collateral Limit Access to Credit in Bolivia*** by Heywood W. Fleisig, Juan Carlos Aguilar, and Nuria de la Peña, (Washington, DC: The World Bank, December 1994).
[7] ***Report of the Working Group on International Financial Crises***, October 1998 (report of the G22, Working Group 3)

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