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SMEs and Collateral[1]

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Different access to credit

SMEs in Latin America get credit on worse terms than SMEs in North America. They pay higher interest rates, get smaller loans relative to cash flow or income, and must repay their loans more quickly.[2]

Higher interest rates

In **Latin America**, a recent survey of interest rates found that banks charge their best borrowers -- large well known firms and the largest of the SMEs -- rates about 6 - 8 percentage points above the government borrowing rate for unsecured or ostensibly secured loans. Outside this select group, borrowers pay more: 12-24 percentage points more than the government rate for unsecured loans; 6-12 percentage points more for loans secured by automobiles, and 5-12 percentage points more for loans secured by real estate. . .

In the **United States**, SMEs[3] also pay a premium over the government borrowing rate. However, that premium is much smaller than in Latin America. SME loans in North America range between 2-10 percentage points more than the government borrowing rate. On average, loans to SMEs are 3-4 percentage above the government borrowing rate.[4]

Smaller loans

Moreover, the typical Latin American SME gets far less credit at those interest rates: compared to North American SMEs, Latin American SMEs, on average, get 1/10 the credit relative to cash flow[5].

What explains the difference?

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 13.0%. However, the typical SME pays a far higher spread over the cost of government funds.

The legal framework for secured transactions

The difference in interest rates between the prime rate and the rate charged on loans to Latin American SMEs , arises from the inability of the typical SME to get any real borrowing advantage from collateral. The typical SME in the United States gets large interest rate concessions because the typical small loan is secured and lenders get real comfort from that collateral: 82% of loans under $100,000 are secured; 96.5% of low risk loans over one year are secured.

Latin American SMEs, however, cannot offer collateral that is economically acceptable to lenders. This inability arises 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. As the borrower's needs for credit grows, collateral will better address these problems of the lending market[6]. However, Latin American SMEs cannot easily graduate to obtain secured loans because, as is explained later, the property of Latin American SMEs cannot serve as good collateral under Latin American law.

The presence of a good framework for collateral explains why small businesses in North America can borrow at terms close to those of large businesses. US SMEs can usually get credit on the following terms. For unsecured loans, for borrowers who offer no collateral and do not own real estate, businesses can borrow an amount that equals about 50% of their income, pay an interest rate about 6-8 percentage points above the government borrowing rate, and take two to four years to repay. SMEs 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 3-8 percentage points above the government borrowing 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. SMEs 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 4 - 5 percent-age points above the government borrowing rate, and take 15 to 30 years to repay. They can borrow an amount equal to 80% to 95% of the collateral.

Latin American lenders respond in the same way to the framework for collateral. At the same time that a well-known bank 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 10 years to repay against the security of a first mortgagee.[7] That is, it offered 10-30 times more credit, at about 2/3 the 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 SMEs, as we shall see, is that Latin American law does not permit much of their property to serve as collateral. This limits SME access to secured credit and raises the cost of both their secured and their unsecured credit.

The Secured Transactions Legal Framework: How it Affects Secured Loans

Lenders want collateral. What collateral can SMEs offer?

Most SMEs 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 inventories of supplies. Artisans have inventories of input materials and completed product. Restaurant operators have cooking and refrigeration equipment and restaurant furnishings. Most have some office equipment. 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. All them have as assets their "accounts receivable" – the funds they expect to be paid from past sales.

Typically, such businesses operate in rented quarters. If they do not own this real estate, they cannot offer it as collateral. Even where a SME 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, SMEs usually can only offer movable property as collateral or attempt to buy this equipment or inventory on credit using the equipment itself as collateral.

However, 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.

Several elements of the Latin American legal framework for secured lending combine to make dealers and lenders behave this way. 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[8]; lenders know this length of time far exceeds the economic life of much movable property that SMEs 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. Even hybrid security interests in Civil Code jurisdictions -- such as *leasing*, the trust and the sale with retention of title -- cannot fully solve the enforcement problem. Even though they can bypass judicial sale, they must still initiate enforcement with troublesome procedural laws that require judicial action to take possession of the leasehold or trust collateral from the debtor. By these features, Latin American law makes the otherwise valuable capital stock of the SME useless to lenders as collateral.

For those fortunate few SMEs 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 titled, although the occupants have legal rights to the property. 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 SMEs serves as collateral and supports SME access to credit. The valuable capital stock of Latin American SMEs does not.

The Secured Transactions Legal Framework: How it Affects Unsecured Loans

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 SMEs 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, such as an installment sale or a small pawnshop loan or a loan by a cooperative, is, itself, another piece of movable property. In Latin America, many merchants and lenders have very good loan portfolios of these small loans. 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 lenders 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 lenders do this? Because the legal frameworks for secured transactions in virtually all Latin American countries, do not permit taking security interests in such portfolios of unsecured loans in a safe and inexpensive way.

Nor is it only small lenders who suffer from this legal problem. Dealers and suppliers can also provide important amounts of credit to SMEs. 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 sale 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.

Dealers in Latin America, however, have no such opportunities. While lawyers may assert that the legal device exists, this is mainly of academic interest. There is actually no legal feature that permits simple, cheap and safe financing that uses accounts receivable as collateral. When the law does permit such transactions, it uses the pledge, assignment of rights or the endorsing (discounting) of negotiable instruments or invoices. These instruments permit only much less secure and much more expensive means of financing than do techniques envisioned in modern law[9] . This promising channel of credit to SMEs 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. [10]

The Reform Record

Unfortunately, we can easily summarize Latin America’s record in the reform of secured transactions: no Latin American country 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.[11] 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 from, weakened from amendment and redrafting, it will make little economic difference if it is passed. Private lenders in Bolivia, including many lenders, continue to use the post-dated check as a guarantee and continue to threaten their non-paying clients with jail, Such lenders either do so directly, or look the other way when their borrowers use these methods to collect among themselves.

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. Even 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 however, limits their possible role in legal reform.

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.[12]

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 SMEs.

Both the IADB and the World Bank have recently begun considering extensive and detailed studies of the failings in secured transactions systems. 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, SMEs 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 SME funding requires private funding[13]. 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 SMEs can get this funding.

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[1] Esta nota está basada en la Nota Breve de CEAL No. 2 sobre microempresas, presentada para el V Foro sobre Microempresas del Banco Interamericano de Desarrollo en Rio de Janeiro, Brazil, 2002.

[2] "Marco Legal e Institutional de Garantías Reales Mobiliarias en Países de la Región", N. de la Peña y H. Fleisig, Presentación en el Taller Regional: Desarrollando la Economía Rural de Puebla a Panamá del Banco Interamericano de Desarrollo, Guatemala (marzo 2001), y publicado en Revista de BANCOS Y EMPRESAS Revista No. 3 Ed. Depalma, Argentina (2001), cuadro no. 4.

[3] Small and medium scale enterprises have a large presence in the United States. More than 99% of US establishments employ fewer than 500 employees. These firms accounted for about 50 percent of US employment, about 45% of total US payroll, and about 41% of total enterprise receipts. (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).

[4] At the same time that the US government was borrowing for 1.63% (90 days) to 2.67% large US SMEs were paying interest rates ranging between 4.75% and 13%. The average interest rate for all commercial and industrial loans made by the US banking system for loans under $100,000 was 5.79%; the rate of interest for loans over $10,000,000 was 3.08%. Federal Reserve Statistical Release E.2, "Survey of Terms of Business Lending, August 5-9, 2002, September 20, 2002.

[5] Idem 2.

[6] "Secured Transactions: The Power of Collateral", H. Fleisig, *Finance and Development* (June 1996).

[7] Data taken from the website of BancoSol, Bolivia (www.bancosol.com).

[8] Ver, por ejemplo, "Argentina: Cómo Las Leyes Sobre Prenda Limitan El Acceso al Crédito," N. de la Peña H. Fleisig, *La Ley* 61 (Marzo 1997); y "Peru: How Problems in the Framework for Secured Transactions Limit Access to Credit," *NAFTA: Law and Business Review of the Americas* 3 (1997) y en *Perfecting Security Interests South of the Border, American Bar Association, Section of Business Law*, Abril, 1997.

[9] "Reforming the Legal Framework for Security Interests in Mobile Property," [Reforma del marco legal para las garantías reales mobiliarias] Nuria de la Peña, *Uniform Law Review* 4 (1999-2): 347, and "Financiamiento de Cuentas de Crédito", ***Estudios de Derecho Comercial,*** Nuria de la Peña, Steven Salant, y Heywood W. Fleisig, (Buenos Aires, Abril de 1997).

[10] *Costo Económico de los Defectos en el Marco Legal Argentino para los Créditos con Garantía de Bienes Muebles*, Nuria de la Peña, Heywood W. Fleisig, Alejandro M. Garro, y Roberto Muguillo: PODER JUDICIAL, DESARROLLO ECONÓMICO Y COMPETITIVIDAD EN LA ARGENTINA, Volumen II, Editorial Depalma, Marzo 2001.

11 "How Legal Restrictions on Collateral Limit Access to Credit in Bolivia," by Heywood W. Fleisig, Juan Carlos Aguilar, Nuria de la Peña, The World Bank: December 1994; and "Legal Restrictions on Security Interests Limit Access to Credit in Bolivia" by Heywood W. Fleisig, Juan Carlos Aguilar y Nuria de la Peña, *The International Lawyer* (Spring 1997).

[12] *Report of the Working Group on International Financial Crises*, October 1998 (report of the G22, working group 3).

[13] Idem 2, table 3.