

World Bank Financial Sector Reform: The Unfinished Legal Agenda

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Introduction

This note briefly sets out some legal gaps in the advice and best practice models presented at this conference.¹ Filling these gaps would always improve these projects and would sometimes mean the difference between sustainable and non-sustainable reform. The note concludes with some considerations about best practice in operational design.

The Bank's Advice and Operations

Improve Macroeconomic Stability

More macroeconomic stability is important for many reasons. But it will not, by itself, address the main problems in expanding access to credit or lengthening maturities of loans. To address these problems, most Bank borrowing member countries (BBMCs) need a legal framework that permits more effective debt collection, particularly in the use of collateral.

Macroeconomic instability can limit longer term financing. With an equal probability of a macroeconomic disturbance every year, the risk that a disturbance will occur increases with the term of the loan. Consequently, risk premia and credit rationing will increase with the term of the loan. When macroeconomic instability constrains lending, rates on longer term loans should be greater than rates on short-term loans.

However, in many BBMCs we see the opposite. Interest rates on 3-10 year mortgages are lower than the rates on short-term loans. The better collateral outweighs the greater macroeconomic risk from the longer-term loan. This underscores the importance of the legal framework for collateral. The weak legal frameworks of most BBMCs allow large holdings of real estate to serve as collateral, but not small holdings of real estate and movable property. The natural consequence is high interest rates, small loans, and short maturities for all borrowers except owners of large properties, typically the rich.

Improve Bank and Financial Market Regulation

Improving supervision and regulation is important but it also will not increase access to more credit or to longer-term credit. Supervision and regulation cannot compensate for the absence of a legal framework to collect debts. Rather, supervision and regulation must conform to the constraints presented by such a legal framework. In most BBMCs, improved supervision and regulation should further restrict access to credit.

About 70% of US loans are secured by collateral, property that the lender can quickly seize and sell when a debtor defaults. The remaining 30% of U.S. loans are unsecured. But those loans are backed up by a legal system that permits lenders to seize the

property of non-paying unsecured lenders or garnish their wages . Such legal systems do not exist in most BBMCs.

Banking systems in industrial countries depend on these legal systems for debt collection. Transferring only their supervision and regulation systems cannot possibly have the desired effect on the financial sectors of BBMCs.

A proper legal framework for finance -- secured transactions, company law, and bankruptcy -- also simplifies regulation by facilitating the financing of non-deposit-taking, non-bank financial intermediaries. A good secured transactions law permits non-bank financial intermediaries to refinance their lending by using their credit or loan portfolios as collateral for refinancing loans. Supervision and regulation should focus largely on deposit-taking banks, so reducing the role of such banks in the financial sector reduces the overall economic risk from failures in supervision and regulation. In the United States, regulated banks supply only 40% of credit. In BBMCs, that ratio is closer to 95%.

A final important regulatory issue is detecting lending to related parties. The commercial code and the commercial registry will specify the parties entitled to bind all businesses, not just corporations. This provides a solid guide to identifying related parties. BBMC commercial registration systems typically do not supply this information. However, Bank operations only rarely address their reform.

Support Development Finance Institutions

DFIs respond to the widespread and correct perception that private lenders in BBMC countries will not supply loans for apparently socially useful projects at terms and spreads that would be privately profitable in comparable conditions in high-income

countries. The fundamental question in designing such an institution, though, is understanding why private lenders in BBMCs do not make these loans.

Typically, BBMC private lenders won't make these loans because their legal system makes inadequate provision for the collection of debts. Therefore, private lenders lend only to people they know very well. This limits access to credit in the formal sector to all except the rich.

However, having a state-supported bank or DFI lend or guarantee loans cannot solve this problem. That simply transfers the risk of non-collection to the state. The same poor legal environment will also prevent the state from collecting. Not surprisingly, DFIs that still lend in those circumstances have lost an enormous amount of money over the years that the Bank has supported them.

Support Insurance

Portfolio diversification and insurance can represent alternative ways of handling risk. Consider an island republic divided into two equal parts that are identical except for weather. There is a 50/50 chance of rain on one side or the other side. When it rains, a crop grows; when it doesn't rain, output is zero. Lenders would find farmers from either side very risky. One solution is insurance: collect fees from a common pool and pay off the losers.

However, another solution is portfolio diversification: a bank could lend to farmers on both sides of the island and, by so diversifying, eliminate all risk of non-payment.

However, in most BBMC countries the law does not permit taking security interests in future crops. Even if lenders could take such a security interest, portfolios of such loans often cannot be diversified. The law may require that loans must actually be transferred. The

legal foundation of modern securitization -- securing loans with other loans -- is not envisioned under their laws. Lenders could not be sure of the priority of their loans secured by the portfolio because the law does not permit using a portfolio of loans as collateral.

Privatize Infrastructure

Private provision of infrastructure has been a Bank aim for years. However, how do you finance that infrastructure? Infrastructure projects usually have three assets: real estate, physical equipment, and accounts receivable from the sale of infrastructure services. Private lenders in the United State routinely finance such U.S. projects by taking each of these components as collateral for a loan.

Why not do this in BBMCs? First, often the private lender cannot take the land as collateral, either because the land is inalienable or because the mortgage collection process is economically ineffective. Second, the lender cannot take the equipment as collateral because the law permits no economically effective way for filing a security interest against that equipment or for recovering it in the event of non-payment. Third, the law often lacks even the concept of taking accounts receivable as collateral. It provides no way of establishing such a security interest in that property or of recovering the proceeds of accounts receivable if the lender defaults.

In those circumstances, the private investor can only make an effectively unsecured loan to the infrastructure project. For an unsecured loan, the legal system in BBMCs typically provides no way to turn default into an enforceable claim against the property of the infrastructure unit that can be enforced. Nor does the law provide an expeditious form of bankruptcy that will permit rapid division or resale of the project assets and payment of the creditors. Faced with these problems, private

investors will demand a sovereign guarantee. As the financier, the government remains intimately involved in the provision of infrastructure.

Support Microfinance²

Though it is still evolving, microfinance has been broadly synonymous with unsecured lending, either through solidarity groups or some other non-collateral mechanism. This is a finance innovation that has played an important role.

However, the informality of the clients of these institutions usually rests on legal provisions that discriminate against women, the young, the poor, the illiterate, and indigenous citizens. These laws effectively force these borrowers out of the legal market. Reforming these laws is essential for poverty alleviation.³ These reforms will undermine the client base of microfinance.

Viable microfinance, moreover, depends on a viable system for collateral. First, for graduating small borrowers from unsecured loans to larger, secured loans. Second, for securitizing microfinance loans to permit refinancing microlending activities where the deposit base is insufficient.

Support Trade Finance

The paper sets out a thoughtfully designed foreign trade-financing project. But why do industrial countries not need such special entities to finance ordinary international trade? For example, the Export Import Bank of the United States finances no more than 1% of US exports. BBMCs need special trade financing because their laws typically do not permit movable property to serve effectively as collateral for loans. Even where the BBMC has a crude system for doing taking such collateral, their laws often set out archaic exclusions that forbid pledging property that does not exist or property that is not owned by the borrower. Consequently, an exporter's

raw materials could not serve as collateral because they are being transformed into the as yet non-existent final product; the importer's imports could not serve as collateral because the importer does not yet own them; and the law may make the exporter's accounts receivable -- the buyer's promise to pay -- useless as collateral. . Therefore, international trade financing in BBMCs is subject to the same limits as any other unsecured finance. Trade financing projects that don't change these laws can have no sustained economic impact.

Support Mortgage Finance

Everybody accepts the importance of mortgage finance. What limits mortgage finance in developing countries? First, many owners or possessors of other land-use rights do not have title. However, their mortgage laws require filing mortgages in the title registry. For a borrower with no title, a potential lender has no place to file.

Second, even where property is titled and registered, BBMC mortgage laws provide for systems too expensive to use with most property; their registration systems do not properly identify the priority of claims, and their systems of foreclosure and eviction require years to execute. A mortgage, under these circumstances, is a much more risky instrument than it is in an industrial country.

Securitization systems that sit on top of such a mortgage system can provide some liquidity to bank holdings of large mortgages but cannot make the underlying "securitized" assets less risky. Attempting to circumvent these legal problems with state-run mortgage systems leaves the basic collection problems unresolved and, because these lenders make the loans anyway, they fail.

Operational Issues

The issues described here are attracting increased and sympathetic attention in the Bank's research and publications.

They have spread in no systematic way, though, to the Bank's lending operations. In an informal survey early last year, no important troubled financial center had a Bank financial sector operation addressing these issues.⁴ This is a good indicator that these reforms are not a high priority for the Bank's central units that review such operations before they go to the Board. A recent similar informal survey of work of the Operations Evaluation Department (OED), revealed no systematic OED review of whether financial sector operations include such legal reform elements or whether, when they did, the project executed those elements successfully. That is probably a good indicator that OED reviewers do not see these reforms as a priority.

The scattered nature of operational support -- never all the countries covered by a Division or in a Department -- is an indicator that support for this reform thins out even at the division chief level. Rather, these reforms are undertaken by individual task managers (TMs) who think these reforms are important. I address the balance of this presentation to them.

Reform: Key Characteristics and Elements of Success⁵

These legal reform operations have some key characteristics that will affect success.

Private support, public opposition

In over 35 projects, CEAL has always had the support of the private sector -- both borrowers and lenders. However, it has rarely had the full support of the government. The reasons for this include government ignorance, desire to keep inefficient laws because they generate

revenue, desire to keep control of state-run registration systems, indifference to improving the operation of the private sector, satisfaction with existing state-run lenders, and support for systems that make loans that don't get paid. The fact that the central government is the key constraint makes this reform an ideal point of World Bank intervention. However, it also means the TM must be vigilant.

Complicated Law

The economic and legal issues in this reform are complex -- as complex for BBMCs as they are for industrial countries. The team of lawyers and economists has to understand this and has to further adapt the best practices of industrial countries to the constraints of the BBMC without sacrificing the economic impact of the reform. The lawyers need experience in drafting commercial laws, not just using in them. The economists need to be able to work with the lawyers, to ensure that drafting choices preserve economic objectives.⁶ The technology people need to be integrated with this team, so that the economist and the lawyers understand technical options and can remove barriers to new technology when they draft the laws. The TM needs to stay on top of these issues and make sure that the output meets the economic needs of the country

Operational Design

In principle, the legal reform could move along step by step with different operations, which would give the TM and the country time to digest proposals. As a practical matter, TMs change, the Bank loses interest, and reform gets dropped. Two successful Bank operations supported this reform with adjustment operations and set passage of law as a prior condition.⁷ This worked, though timetable for preparation was tight. However, that strategy requires a determined TM who can draft tight conditionality on a few

conditions and defend that decision during management review and in discussions with the government

Elements of Failure

Lawyers working without Economists

Lawyers working without economists will often modify draft laws in ways that undercut economic reform. They may do this because they do not understand the link or cannot explain it to the government or Bank management. A good reform cannot be taken off the shelf and applied without modification.

Put the borrowing member government charge

BBMC governments will typically not push this reform forward. They will use project funds to hire local lawyer friends who do not understand cutting edge issues in designing these laws or the history of their reform in industrial countries. Consequently, they compromise on key economic details. The supervision budgets of most TMs will not be sufficient to control this.

Finance a registry with no proper legal reform

This reform is not a technical problem. It is a legal problem with a technical aspect. A new filing archive or registry without accompanying legal reform will have no economic effect.

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¹ More complete theoretical and empirical treatments of these issues appear at the CEAL website, www.ceal.org. Some cross-country measures of the importance of these reforms appear in the "Doing Business" surveys of the World Bank, available at www.worldbank.org.

² See also "Microenterprises and Collateral", www.ceal.org and www.iadb.org

³ "The Right to Borrow", www.ceal.org, www.worldbank.org

⁴ "Should the Bank and the Fund Support the Reform of Secured Transactions?", www.ceal.org

⁵ For further discussion, see "The Role of Lawyers in Legal Reform: The Case of Debtor-Creditor Laws", www.ceal.org

⁶ The draft law for Romania, for example, addressed enough complex issues that it was considered publishable in a refereed law journal. Nuria de la Peña and Heywood Fleisig, "Romania: Law on Security Interests in Personal Property and Commentaries", 29 *Review of Central and East European Law* 2004 No.2, 133-217.

⁷ Based on early indicators, the Romania reform has been enormously successful, with over 600,000 security interests filed in the first four years of operation. See "Secured Transactions Reform: Early Results from Romania ", www.ceal.org. ...