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Secured Transactions: The Power of Collateral

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Secured Transactions: The Power of Collateral

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In many developing countries, businesses are unable to get low-cost, long-term loans from private lenders to finance investment projects. Reforms that make it easier for borrowers to use movable property as collateral would give comfort to lenders, stimulate investment, and boost productivity and growth.

THE FIRST question any private lender asks is, "How do I get my money back?" Given the risks involved in lending—borrowers may be unlucky, unwise, or dishonest—what conditions give comfort to lenders?

Two basic loan transactions have evolved in private markets: unsecured and secured. When a borrower offers an unsecured promise to pay, the lender must rely on the borrower's reputation, or trust that the borrower will pay back the loan in order to have access to future loans. In secured transactions, promises to repay are backed by collateral that lenders can seize

and sell in the event loan payments are not made as agreed. Collateral may be real estate or personal property—tangible personal property such as inventory, equipment, livestock, and tractors; or intangible personal property such as unsecured accounts owed to merchants (accounts receivable) and secured agreements (chattel paper). Secured transactions have advantages for borrowers and lenders alike—transaction costs are lower and lenders do not need to gather as much information about borrowers.

The issue of collateral is one of great economic importance. When borrowers cannot use their assets as collateral for loans and cannot purchase goods on credit using the goods themselves as collateral, interest rates on loans tend to be higher to reflect the risk to lenders. In many developing countries, where legal and regulatory constraints make it difficult to use movable property as loan collateral, the cost of loans makes capital equipment more expensive for entrepreneurs relative to their counterparts in industrial countries; businesses either postpone buying new equipment or finance it more slowly out of their own limited savings. Small businesses, in particular, are hit hard by the scarcity of low-cost financing, but the whole economy suffers because the lack of new investment dampens productivity and keeps incomes down. Estimates put welfare losses caused by bar-

riers to secured transactions at 5–10 percent of GNP in Argentina and Bolivia.

Legal barriers

Movable property is widely used as collateral in the industrial countries. About half the credit offered in the United States is secured by some kind of movable property; about two-thirds of bank loans are secured by either movable property or real estate, and nonbank institutions that lend against movable property—such as leasing and finance companies—do almost as much lending as banks.

In contrast, private lenders in developing countries rarely make loans secured by movable property unless at least one of two conditions is satisfied: borrowers must own real estate that can be attached if they do not pay, or borrowers must place the movable property under the physical control of the lenders, as in a pawnshop or warehouse financing. If neither of these restrictive conditions can be met, private lenders rarely make loans secured by movable property. They may still make unsecured loans, but these are likely to be smaller loans with higher interest rates and shorter maturities. This phenomenon has been studied in a broad range of countries with different traditions, income levels, macroeconomic outlooks, religions, and levels of urbanization and industrial activity. The difficulties in securing loans with movable property have

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been observed in Africa, Asia, Eastern Europe, and Latin America—in countries with legal and regulatory systems modeled after the civil codes of continental European countries, as well as in African and Asian countries whose systems are modeled after British common law.

What prevents the use of movable property as collateral in developing and transition countries? Three obstacles stand out:

- The *creation* of security interests is difficult, expensive, and uncertain.

- The *perfection* of security interests—the public demonstration of their existence and the establishment of their priority—is not effectively possible.

- The *enforcement* of security interests is slow and expensive.

These abstract notions can be understood more easily with an example. Compare the financing available to farmers raising cattle in Uruguay with that available to their counterparts in Kansas, in the United States. Uruguay and Kansas have similar topographies and well-educated populations interested in advanced technologies and able to apply them, and both are world-class exporters of beef cattle. In Kansas, private banks view cattle as one of the best forms of loan collateral; this is also the view of the bank examiners at the Federal Reserve Bank of Kansas City. Banks with “cattle paper” are seen as solid whereas banks with “exposure to farm real estate” are seen as risky. By contrast, in Uruguay, because of flaws in the legal framework governing secured transactions, private banks and bank examiners prefer real estate as collateral for loans; they consider a pledge on cattle worthless as collateral. The unacceptability of cattle as collateral applies to all types of transactions, including sales of cattle on credit, sales of cattle financed by third-party lenders like banks or finance companies, or working capital loans for other purposes that might be secured by cattle.

Creating security interests. First, it is difficult to create a security interest in Uruguay. Suppose a private bank in Uruguay were to lend against 100 cattle worth \$200,000. Uruguayan law calls for a specific description of the property that is pledged. A pledge against cattle might identify the individual cows pledged by name (Bessie, Elmer, etc.) or by the numbers tattooed on them. The need to identify the collateral so specifically undermines the secured transaction because the bank must ensure that the cattle designated in the pledge are available to be seized in the event of nonpayment—the lender is not

allowed to repossess a different group of cows.

As a result, the supervision of such loans is costly. It would not be enough, as it is in Canada and the United States, for example, to verify simply that there are enough cattle in the farmer's field; in Uruguay, the loan officer would have to verify that the cattle in the field are the ones specifically identified in the pledge. The Uruguayan bank might try to get around this problem by using a more general description of the collateral in the pledge contract—say, “100 calves.” But, with a loan of one year's maturity, the calves would become cows, bulls, or steers, and the enforceability of the contract would be clouded. In Canada and the United States, however, a binding agreement can be written with a floating security interest in “\$200,000 worth of cattle.” Moreover, in Uruguay, the bank would have to worry that the farmer might sell the cattle without notifying the bank, whereas a Canadian or US bank would have a continuing security interest in the proceeds of the sale and could automatically attach the proceeds—whether they were placed in another bank or used to buy a tractor.

Perfecting security interests. Second, Uruguayan lenders cannot easily find out whether prior and superior claims exist on their security interest. In Canada, Norway, and the United States, for example, all security interests against property are registered; the registries are public and indexed by borrower, by description of security interest, and by other relevant information. Lenders can easily conduct a thorough search to ensure that they have identified any outstanding security interests; security interests that are not registered have no legal standing. By contrast, the registry in Uruguay files security interests in chronological order and does not index them. The only way lenders can find out whether a security interest exists is if borrowers inform them.

Enforcing security interests. Finally, repossession and sale of collateral takes longer in Uruguay than in Kansas. In Kansas, repossession and sale of cattle takes one to five days and can be contracted between private parties. Typically, judicial intervention or the action of government officials is unnecessary. In Uruguay, the process requires six months to two years. In the case of cattle, there is a risk that the collateral will die, disappear, or get sick. Not surprisingly, under these conditions, lenders demand collateral that is sure to outlast a lengthy adjudication process—in other words, real estate.

Economic impact

In Kansas, the ease of creating a security interest, the inexpensiveness and high degree of confidence that can be attached to the perfection of a security interest, and the speed and low cost of enforcement explain why farmers can get private loans for a large fraction of the value of their cattle at interest rates close to the prime rate. The difficulty of using cattle as collateral in Uruguay explains why Uruguayan farmers cannot get any financing for cattle. However, although both rich and poor farmers are affected, rich farmers own land and have access to some credit by virtue of their real estate holdings; poor farmers, who are often tenants, have to use their own savings to finance the additional investment required to raise their incomes. But neither rich nor poor farmers have the easy access to credit enjoyed by their Canadian and US counterparts (and competitors in the world beef markets).

With minor adjustments, the same story can be told for Argentina, Bangladesh, Bolivia, Bulgaria, Mexico, and other developing and transition economies, both urban and rural, regardless of whether their legal systems are based on civil or common law. And the same story can be told, with slight variations, for lending against all movable property in developing countries, except for loans and leases secured by automobiles or loans secured by goods stored—under the control of lenders—in warehouses and pawnshops. Barriers to using movable property as collateral block access to credit and make it difficult to obtain term financing for investment. They also make it difficult to reform banking systems burdened by risky, unsecured loans. Lacking usable collateral, developing countries do not enjoy the major benefit of financial markets—the transfer of funds from savers with limited investment opportunities to investors with insufficient savings to finance profitable projects.

Access to credit. Even in the best of circumstances, poor people do not often go to banks for loans to finance small equipment purchases. But, in industrial countries, small-scale farmers and entrepreneurs can usually purchase equipment, livestock, or inventory on credit from merchants. In developing countries, however, merchants willing to sell on credit to poor customers whose reputation is good have their own problems gaining access to credit: legal constraints on collateral prevent merchants from getting financing secured by their inventories or accounts receivable. If merchants want to extend

credit to microenterprises and small and medium-sized businesses, they typically must do so out of their own capital.

Term finance. Although operators of small industrial operations may find it possible to finance "plant"—real estate—with a mortgage, it may be impossible for them to get medium-term loans for working capital or equipment. The reason is not the loan maturities—the same lenders happily make longer-term loans secured by real estate—but the underlying collateral (equipment and inventory) that is unacceptable to lenders. In the United States, movable property accounts for half of the nonresidential capital stock and two-thirds of corresponding gross investment. The difficulty of financing this investment in developing countries greatly hampers industrial and agricultural development.

Bank reform. In developing countries, well-regulated banks typically only make loans secured by real estate or make unsecured loans to those who give evidence of owning real estate. Because the costs of mortgaging property are usually quite high, most bank loans are actually unsecured but made to borrowers who own real estate on the theory that, in the event of default, banks can file a lien against the real estate.

Most bank loans in industrial countries are secured—70 percent in the United States, for example. The difference between industrial and developing countries is striking—nearly 90 percent of bank loans in Argentina are unsecured, and the figure is similar for Bulgaria. Unsecured banking systems are necessarily more risky and prone to failure. And, because mortgages are unregistered, a lender has no idea how many times a borrower has used the same property to indirectly back up a loan. If the borrower defaults, only the bank that files a lien the fastest will be able to back up the loan. Inability to use anything else as collateral means that about half of the nonresidential private capital stock is inaccessible to banks as security for loans.

Capital markets. The World Bank has supported capital market reforms that encourage the securitization of equipment loans, real estate mortgages, and credit card accounts receivable. Such mechanisms can change the conduits through which financing takes place, improve the allocation of capital, and promote competition in the financial sector. However, their effectiveness is limited by the difficulty of creating, perfecting, and enforcing the underlying secured transactions. At the most rudimentary level, the easiest securiti-

zation is one where an enforceable security interest is given in the underlying paper. Successful securitizations in Canada and the United States are based on predictable collection rates for underlying mortgages, chattel paper, leases, and accounts receivable. In countries where the underlying loans cannot be collected or leases enforced, securitization offers only limited actuarial benefits. And, if a government guarantees such securitizations, it risks accumulating large uncollectible debts.

Leasing, a type of secured transaction, may facilitate repossession by not requiring proof of ownership. Even so, repossession can be a lengthy process. Leasing is also subject to problems of creation and perfection. When these problems are not addressed, leasing primarily benefits those who can already borrow.

Seeking solutions

Some analysts have concluded that, if the private sector is unwilling to provide credit, market imperfections justify the creation of state agencies that make loans. However, this strategy has severe limitations. First, state lenders are no more able to collect these loans than are private lenders. The main difference is that state lenders are willing to make loans despite the risk of losing money. Not surprisingly, they have lost a great deal. Second, because borrowers know that these loans are hard to collect, such lenders tend to attract a different type of client—one who specializes in getting loans from the government, not one who specializes in investments with high returns. What typically takes place with state agency lending programs is a great deal of lending, little repayment, and not much positive impact on economic growth.

To get around the difficulties of repossession and sale of collateral, some lenders simply seize and sell the collateral without the sanction of law. Some leasing operations disguise their underlying financial nature and pretend that their seizures are not repossessions, hoping that the judicial system will not uncover the equivalence of the transactions. For large and valuable pieces of equipment, dealers in every developing country tell tales of dispatching armed men and bribing police to recover machinery at gunpoint.

In some countries, lenders use a postdated check to convert the civil offense of nonpayment into a criminal act. They may demand a postdated check in the amount of both the loan and the interest. On the date the loan is due, the lender requests payment. If the borrower cannot pay, the lender

deposits the check in a bank. If the check is returned unpaid, the lender can take the check, stamped "check without funds," to the police station. In Bolivia, for example, writing a check without funds is prima facie evidence of a criminal act of fraud. The borrower may be arrested. If he or she fails to raise the funds, conviction is certain. (The sentence in Bolivia for writing bad checks is about four years.)

Lenders in the formal sector, obviously, cannot use such collection techniques; the risk of civil and criminal damages is too great. Therefore, the resources of the formal sector are not tapped for credit, and movable property remains the province of lending techniques in the informal sector. This is costly for developing economies—faced with the prospect of jail if they are unable to repay, business people tend to borrow less and borrow only for operations with very high returns—and costly for society, because incarcerating risk-taking entrepreneurs stifles development.

Governments can implement a number of legal reforms to address the fundamental problems in credit markets that make it so difficult to secure loans with movable property:

- Changing the law to permit a greater variety of security interests in a wider range of transactions by a broader group of people.

- Making registry records public, reforming state-operated registries, restructuring public registries to permit competition, and privatizing registry services or allowing private registry services to compete with public ones.

- Speeding up enforcement and making it cheaper, changing the law to permit private parties to contract for nonjudicial repossession and sale, and, when possible, allowing private parties to contract for repossession and sale without government intervention. [F&D]

This article draws on the work of several lawyers and economists who have advised the World Bank on a variety of issues related to the Bank's lending activity and economic and sector work in the area of secured transactions.