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Peru:

How Problems in the Framework for Secured Transactions Limit Access to Credit

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Executive Summary

Peru: Access to Credit and the Framework for Secured Transactions

i. Improving access to credit in agriculture is often seen as a key element in rural development strategy -- because projects exist that could increase the incomes of farmers and other rural businesses if they only had access to credit. Peruvians interviewed in the course of this study offered many examples of such investments: equipment dealers believed that increases in sales of 200% to 300% were possible at current interest rates if they were able to sell with four year loans instead of one or two year loans; a broad range of producers -- coffee, fruit, cotton, vegetables, and timber -- believed that loans for seed, fertilizer, pesticides and fungicides could double output.

ii. Similarly, access to credit is often seen as an important tool in attacking rural poverty. Partly because profitable projects exist that could raise income. Partly because increasing access to credit would achieve other social objectives, such as improving the independence and self-reliance of the target groups, increasing agricultural self-sufficiency, or permitting the able rural poor to swiftly raise their earning prospects. Again this was broadly confirmed in the interviews conducted in the course of this research: while access to credit in Peru was unduly limited even for the largest and most prosperous companies. However, the smallest producers had limited access to credit, only if tied into an established exporting chain; otherwise, they had no access to credit at all.

iii. There has long been concern in Peru that banks and other private formal sector institutions do not deliver sufficient credit to farmers and other rural businesses. Of particular concern has been the absence of credit to small farmers and to small and medium-scale enterprises. Consequently, the government, and bilateral and multilateral donors have focused on different institutional innovation that could improve the delivery of such credit.

iv. At first, the government attempted to disburse these credit lines through state banks, and state guarantee funds (like Fondeagro, Banco Minero, Banco Agrario). These attempts were a costly failure. Private lenders would not make these loans because they were too risky. When public lenders made them, they found them indeed uncollectible. Moreover, public lenders faced political pressures to charge uneconomically low interest rates, to lend to politically favored groups who were not always able to pay, and were less enthusiastic in debt recovery than would have been private sector institutions. Poor performance, combined with visible failure to reach target groups, led to plans to dissolve public lending institutions and guarantee funds.

v. In its place, the government and donors set up a system that would disburse through private for-profit institutions. This improved the efficiency of these onlending operations.

Private lenders, in the framework of a vastly strengthened systems of supervision and regulation, took great care to disburse only where loans could be collected. However, in most cases this improvement in efficiency took place at the expense of reaching the target groups -- the price of improved efficiency was that target groups had even less access to credit.

vi. In the recent years, Peruvians introduced new institutions, such as *cajas rurales*, and *empresas comunales* and *semicomunales*, as well as new institutions with new legal features for financing, like leasing companies.

vii. These steps are promising. However, in Peru, legal, regulatory, and institutional features of the Peruvian economy continue to block access to credit. They restrict formal sector institutions in their direct delivery of credit to farmers and small and medium size enterprises. They limit formal sector financial institutions in their refinancing of credit extended by rural equipment dealers and suppliers; they hamper innovative new institutions that aim at delivering such credit; they make it difficult for innovative institutions to form links with formal sector institutions.

viii. The authors interviewed producers of asparagus, fruits, coffee, cotton, colorants, fish meal; manufacturers of textiles, leather merchandise and fruit juices; distributors of construction, mining and farm machinery; traders in farm products; sellers of fertilizers and pesticides; the Superintendency of Banks regulatory team; COFIDE directors and its rural development department; CONASEV (the regulatory agency for securities); business lawyers; registry officials; medium and large banking institutions; financial companies; retail businesses; and key interest groups, including the Chamber of Commerce; the Chamber of Forestry; and the Chamber of Industry.

ix. All business interviewed were both lenders or credit-sellers and borrowers or credit buyers in the Peruvian credit chain. In each case, however, access to credit was typically limited to the value of real estate they could offer as collateral, using a mortgage and borrowing from only one lender. For a few commodities, additional credit was available through warrants on merchandise in warehouses; for a few lenders, the pledge on equipment was useful.

x. However, such provision of credit does not serve the needs of the Peruvian production system very adequately. For example, in the practice of the trade in coffee production, is a system of rural *acopiadores* purchases coffee from the final producer, who typically is a smallholder operating on a small plot. The *acopiadores* will establish a working relationship over years with their producers and extend credit for fertilizer, fungicide, pesticides. The amount of credit they offer will depend on their confidence in the ability of the final borrower to repay. There is no real guarantee.

xi. The amount that the *acopiador* can lend, however, is limited by the *acopiador's* own access to capital. The *acopiador* could, of course, get a mortgage on real estate, but the

acopiador has few assets tied up in real estate. Rather, the acopiador has movable property as assets: tangible movable property -- trucks, inventories of green coffee, or fruit or cotton-- and intangible movable property -- accounts receivable from the small producers, accounts receivable from the coffee exporters in the cities. All of this movable property must be financed from the acopiador's own capital; none of this movable property serves as collateral for a loan that would permit the acopiador to expand his operation by offering more credit to his producers.

xii. Some borrowers give the appearance of using their machinery, inventories and receivables as collateral. Typically, though, that financing was illusory. Rather, banks would give firms a credit line based on the firms' real estate holdings -- bienes inmuebles. Subsequent financing secured by movable property would usually be deducted from this credit line. No additional credit was granted to companies that increased their accounts receivables with more sales or that had double their movable property inventory through a more efficient production of agricultural produces. Their available credit reached a ceiling determined by their ownership of real estate, and no credit was granted secured solely on their assets in movable property.

xiii. Few types of property, besides real estate, seemed to "really" serve as collateral.

xiv. In each case, legal and institutional limits in using movable property as collateral for loans limited access to credit to profitable transactions and growing businesses.

xv. These limits in using movable property as collateral for loans do not arise from macroeconomic problems or from high intermediation spread, but from problems in the Peruvian secured transactions framework that makes movable property a very risky collateral.

xvi. These problems in the Peruvian secured transactions framework have been observed in other countries such as Argentina, Mexico, Uruguay, Bolivia, Peru, Honduras, and El Salvador, that share Peru's Civil Code tradition. But it is not confined to these countries. Bangladesh, India, and Pakistan are Common Law countries with similar problems that arise from an inadequate framework for security interests in movable property.

Problems in Laws and Regulations Applicable to Secured Transactions

xvii. In Peru, several features of their secured transactions framework limit access to credit in agriculture. This defective framework for secured transactions makes it difficult for formal sector lenders to provide supplemental financing through the natural conduits of rural credit, especially buyers of farm products, dealers and suppliers of farm inputs.

xviii. The problems in the framework for secured transactions involve problems in creating, perfecting, and enforcing security interests in movable property.

Problems in creating security interests arise from:

- restrictions in the creation of security interests that float (for example, against good whose composition changes, such as rotating inventory), that attach to the proceeds of the sale of collateral (for example, when deposited in banks or used to purchase other merchandise), that may attach to intangibles (like a group of cuentas por cobrar or pledges) or that may only be created by some creditors, (for example, only bankers may serve as trustees).

In Peru, coffee and fish meal could serve as collateral when combined with warehouse receipts. However, the Peruvian framework for warehouse receipt security interests is not well suited to the needs of trade that may require rotating inventories, such as processing products in a factory, like colorants, or very perishable goods, such as fruit, or fresh vegetables. Accounts receivables represented by negotiable instruments can serve as collateral in Peru. However, a system that requires transferring the receivables does not permit more than one lender against the same pool of accounts, nor does it permit rotating the receivables. Therefore, the discounting of drafts rarely provided additional credit.

Problems in perfecting security interests arise from:

- registration and priority rules that place first rank lenders in a "super" priority position, limiting financing by other lenders; or that give to junior creditors priority over senior creditors;
- the absence of a registration system for transfers or of security interests in accounts receivables and warehouse receipts;

Problems in enforcing security interests arise from:

- enforcement procedures that are long and costly relative to the economic life of most movable collateral.

Problems in Institutions involved in Secured Transactions

- xix. Several institutional features limit access to credit:
- Public registries seem expensive to search, not sufficiently open to public access, and technically weak. These problems raise the cost of registering security interests in small real estate holdings, movable property, and accounts receivable that will be essential in opening channels of credit to rural borrowers. Where land holdings are small and of low value, these costs will make registration of security interests prohibitively expensive and drive the small farmers out of the credit market.
 - Credit reporting systems are just beginning. Lenders now seem to have no systems for making credit decisions based on past lending performance. Consequently, borrowers who are not well-known outside their geographic areas, especially farmers, have no way to gain access to credit by publicizing a strong history of timely payment.
 - Superintendency of Banks rules on personal lending seem to consider the use of cuentas por cobrar as collateral as a risk exposure against one borrower instead of many. This lending is then limited by restrictions on loans to one party.

Other Legal and Regulatory Barriers

xx. Several interviewees expressed their concern that Superintendency rules on movable property collateral requirements seem restrictive, and that some rules on collateral requirements might be lowered for some loans that can put extrajudicial enforcement clauses in lending documents and by requiring improved or private registration system for security interests in the collateral that secures those loans.

xxi. Lack of competition among some lending institutions. Some laws control the operation of recently created lending institutions, like cajas rurales. However, within that set up, the requirements limit the operations of cajas rurales both with respect to geographic territory and type of lending instrument in ways that seem to have no strong basis in public policy. This problem requires further research.

I. Introduction

1. Macroeconomic stabilization, sectoral policy reform and trade liberalization have greatly altered the incentives facing workers, farmers, and business people in Peru. To respond to new opportunities and challenges, producers must make large medium- and long-term investments. Machinery, inventories, and working capital are all needed to take advantage of opportunities for production and export presented by the rapidly changing environment for economic reform.

2. This adjustment requires financing. Yet farmers and business operators in Peru face enormous barriers in getting credit. Typically, they can only get credit if they can offer real estate as collateral, show they own real estate that could serve as collateral, or offer the guarantee of someone else who owns real estate. Typically, they cannot get loans to buy movable property -- such as machinery, inventory, livestock, fertilizer, or pesticides -- secured by that property or by the movable property, such as crops, that those purchases would produce. Nor can they buy much of that property on credit.

3. In the United States, movable property amounts to half of the non-residential private capital stock; it amounts to two-thirds of corresponding gross investment. This property cannot guarantee loans in Peru. At the same time, many Peruvian businesses operated from rented quarters; farmers operate on rented land or own too little land to qualify for a mortgage. The immense need for movable capital is matched only by the inability to finance it. The discrepancy places an enormous economic burden on Peruvian farmers, business operators, and consumers.

4. In addition to a basic legal and economic research concerning this problem in Peru, this report draws on two weeks of intensive interviews with business people, farm operators, and operators of financial institutions in Peru. Those interviewed included producers of asparagus, fruits, coffee, cotton, colorants, fish meal and minerals; manufacturers of textiles, leather merchandise and fruit juices; distributors of construction, mining and farm machinery; traders of farm products; sellers of fertilizers and pesticides; the Superintendency of Banks regulatory team; COFIDE directors and its rural development department; business lawyers; registry officials; medium and large banking institutions; financial companies; retail businesses; the Vice-president of Peru; the Chamber of Commerce; the Chamber of Forestry; the Chamber of Industry; and CONASEV (the regulatory agency for securities). All business interviewed acted both as lenders and borrowers in the Peruvian credit chain.

5. This report describes the how problems in the framework for secured transactions restrict the use of collateral in Peru and prevents these agents from making transactions profitable for themselves and for the Peruvian economy. It discusses the legal and institutional roots of this problem; it considers alternative explanations for the lack of financing for movable property; and it sets out the economic consequences for Peru of

problems in the secured transactions framework. The report concludes by discussing legal, regulatory and institutional options to address these problems and sets out several strategies for consideration by the government, consumers, and business people in Peru.

II. The Economic Importance of the Secured Transactions Problem

6. Problems in the existing framework for secured transactions incur a high economic cost for Peru. They limit direct participation of banks in financing movable property. They retard the development of other sources of financing. These problems limit access to credit for those who do not own real estate. This restricted access to credit lowers Peruvian GDP. It diminishes opportunities for all Peruvians, especially small farmers and businesses. This chapter describes the general practical role that collateral plays and sets out its underlying economic logic; it explains how the framework of secured transactions affects lending, it sets out the overall consequences for economic efficiency and the distribution of income and wealth; it discusses the likely size of this effect.

A. The Practical Importance of Collateral

7. As a practical matter, collateral is important. In the industrial countries, lenders will typically lend more at lower interest rates when collateral is offered. The amounts lent and the rates charged will differ with different types of collateral. One well known U.S. financial institution, for example, will lend borrowers about six months' pay on their signature alone, about two years' pay on loans secured by movable property such as boats, cars, or recreational vehicles, and about four years' pay on loans secured by real estate. No evidence of ownership of real estate is necessary for the first two loans. Lenders also typically charge lower interest rates on loans secured by movable property than they do on signature loans; they usually charge lower interest rates on mortgages than on loans secured by movable property when the length of the loan is similar. Other commercial institutions follow similar practices.

8. In Peru, like many other Latin American countries, lending follows a different pattern. Most loans from formal sector institutions are secured by a mortgage or by the personal guarantee of someone who owns real estate.¹ This second type of collateral is like a "potential mortgage" -- partly it functions to demonstrate the wealth and credit worthiness of the borrower, partly, it raises the prospect that the lender could attach the real estate of the guarantor in the event of a default.²

¹ Peruvians often use the Fianza (guarantee) By means of this contract, the guarantor agrees to comply with the obligation of the debtor in case of default. The guarantor must own property sufficient to cover the obligation and the property must be attachable within Peru ["persona que sea propietaria de bienes suficientes para cubrir la obligación y realizables dentro del territorio de la República" COD.CIV., art. 1876)]. Therefore, the most accepted guarantees are those of banking and financial institutions, since these institutions can most easily comply with the property requirements. However, a fianza does not avoid a collateral problem for a debtor: to obtain a fianza, the debtor must give collateral to the guarantor. See articles 1868 to 1905 of the Civil Code.

² Farmers in Peru face a worse situation. Not even real estate is good collateral. First because numerous exception to the "first to file rule" (discussed below) can make a senior mortgagee lose

9. What is missing in Peru, as compared to systems of secured transactions in industrial countries, is substantial lending that is ultimately secured only by movable property.

10. A flavor of the problem of using movable property as collateral can be seen by comparing bank lending for coffee and bank lending for tractors. In Peru, there is a small but growing business of financing coffee inventories using warehouse receipts. In these transactions, real estate is never mortgaged and ownership of real estate is not necessary to get the a outside Lima, in smaller towns. Some banks and acopiadores are making these loans. Some of these borrowers are residents of rural towns and some are farmers. Yet the very same banks and acopiadores that lend on the warehouse receipt of coffee will not lend on warehouse receipts of fruits to the same borrowers. As this example indicates, the problem does not arise from inherent limitations of banks or from the inherent nature of farmers. Rather, it arises from the nature of the collateral: a warrant of coffee is acceptable and fruit is not. As the paper shows, lenders are rational in making this distinction, which arises from the greater ease, in Peru, of repossessing and selling a warehouse receipt of coffee as compared to a warehouse receipt of fruit.

11. Such limitations on acceptable collateral can represent an important constraint on credit, because the ultimate magnitude of lending secured by movable property can be enormous. In the United States, for example, lending secured by movable property amounts to about 40% of total credit, and total credit is about twice GDP. In Peru, lending secured by movable property does not extend much beyond limited lending for of warehouse receipts of some produces. We will discuss the economic consequence of this later.

B. The Economic Roots of the Importance of Collateral¹

12. The practical importance of collateral is indisputable. Some writers, however, have questioned the logical roots of the concern about collateral. If the logical roots of the defense of collateral are imperfect, then we would need to look elsewhere for the roots of the problem of access to credit. The following report briefly examines the issue here.

his claim. Second, because the land of small farmers, is likely to have boundary, titling or successor claims. Therefore even if registries were to function well, the failure of priority rules to enforce a senior registered mortgage make it risky for a lender to collect against the mortgaged land. In Peru, it seems that real estate is more used to show wealth and credit worthiness. In this respect, the situation in Peru is worse than in other neighboring countries, where at least real estate collateral supports some lending for small farmers.

³ See Heywood Fleisig, "Secured Transactions: Their Economic Logic and Economic Impact" [forthcoming, 1996]

13. **Can interest rate adjustments substitute for collateral?** Some ask why lenders don't simply charge higher interest rates to riskier lenders, matching the risk and the expected return. In such a world, lenders without collateral would pay higher interest rates but would still get access to credit. Following through this chain of reasoning, a framework for secured transactions would explain why such borrowers with poor collateral paid higher interest rates than borrowers with good collateral. However, this hypothesis does not explain what we observe in Peru -- that borrowers with poor collateral seem totally unable to get loans.

14. Why is this? Because credit markets cannot completely ration borrowing through changes in the interest rate. Since the lender can never be totally sure of the borrower's willingness or ability to pay, a borrower's agreement to pay a high interest rate is ambiguous. Such a borrower may have a high return project; but such a borrower may also intend to pay neither the interest nor the loan. In a world with such uncertainty, collateral can inexpensively demonstrate the borrower's faith in his promise to repay.

15. **Can equity substitute for secured lending?** Debt financing and equity are interchangeable at the margin. Consequently, it could be argued that a viable project that is not financed with borrowing would be financed by equity investment. If that were the case, a poor framework for collateral would only shift the balance away from debt financing and toward equity. There would be overall economic cost arising from a defective system of secured transactions: all profitable projects would be financed eventually.

16. For individual economies, where firms can easily issue stock, then the problem of not being able to borrow may be less severe. In Peru, however, the equity market cannot provide a good substitute for the ability to borrow using collateral. First, only a few large corporations are able to issue equity because of the high costs of underwriting public stock issues. Second, Peru law classifies most small farmers as individual proprietors not as a corporation; hence, they cannot issue equity.

17. Where stock markets do not function well, and equity must be internally financed, the proposition that equity and debt can substitute at the margin will be small comfort to Peruvian enterprises. Under those circumstances, the rate at which profitable investments take place will be limited by the income and savings of the individual proprietors. So, for example, where the framework for secured transactions was sound, a \$10,000 investment in a tractor with a rate of return above the interest rate could be funded immediately, however might require five years of saving if it were internally financed. The farmer with access to credit will have higher output and income throughout the investment period.

C. The Secured Transactions Problem Pervades Peruvian Credit

18. The Peruvian framework for secured transactions limits the ability of formal sector lenders, principally banks, to finance the movable property needs of Peruvian farmers and business operators. They will not finance equipment, inputs or, for the most part, inventories of agricultural products.

19. But the overall effect of the secured transaction problem is much more pervasive: it permeates access to credit in Peru. Obviously, it limits direct access of farmers to credit for the purchase of equipment. But it also limits indirect access to credit by choking off the supply of credit to dealers who might otherwise lend to farmers. Banks, finance companies, and manufacturers are unwilling to finance a dealer's stock of new and used equipment beyond the credit the dealer could obtain based on real estate holdings. Related problems in the framework for secured transactions make banks and finance companies unwilling to purchase the debt contracts generated by the dealer. Limits on secured transactions in Peru, therefore, restrict access to credit through many channels. It is these channels that provide ample flows of credit to rural producers in the industrial countries.

20. As noted above, this report involved extensive interviews with operators of commercial, farm, and financial businesses in Peru. All business interviewed were lenders and borrowers in the Peruvian credit chain. In each case, however, access to credit was typically limited to real estate, generally through the use of a mortgage on the real estate with only one lender. For a few commodities additional credit was available through warrants on merchandise in warehouses; for a few lenders, the pledge on equipment was useful.

Farmers

21. Compared to farmers in industrial economies, farmers in Peru are very restricted in the sources of their financing:

They cannot pledge their livestock or equipment to borrow working capital for seed, fertilizer, pesticide, and fungicides.

They cannot purchase livestock or equipment on credit, by making a down payment and permitting the capital purchased to serve as security for the loan.

Without offering a mortgage on the land, they cannot borrow against "fixtures" --movable property affixed to the real estate. Nor may they purchase such equipment on credit.

They often cannot pledge their stored production to borrow working capital.

They cannot pledge their standing crop to obtain working capital, Not because the law does not recognize a *security interest* in "future" crop. In Peru, no security interest may safely attach to inventory that floats and changes.

Without offering a mortgage on the land, they cannot borrow against "fixtures" --movable property affixed to real estate. Nor may they purchase such equipment on credit.

They often cannot pledge their stored production to borrow working capital.

They often cannot pledge their standing crop to obtain working capital, not because the law does not recognize a *security interest* in "future" crop. In Peru, no security interest may safely attach to inventory that floats and changes.

22. In each case, these problems arise from defects in the framework for secured transactions.

23. **Pledging livestock and equipment.** Farmers cannot use their equipment or livestock as collateral for a bank loan. In some cases, the law does not permit a safe instrument to be written against this collateral. In all cases, the judicial procedures to seize and sell equipment are longer than the time it takes for livestock and equipment to lose their economic value. Obviously, creditors will see that collateral as too risky if they can not safely collect against it.

24. **Purchase livestock or equipment on credit.** Nor can Peruvian farmers buy livestock or equipment on credit. Where sellers required a security interest in the good, the dealer would have the same problems in creating and enforcing such a security interest as would a bank. However, in many cases, dealers are intimately familiar with the payment characteristics of their rural customers. They are willing to lend without security to them. However, in these cases, as we will discuss below, the dealer is limited by flaws in the framework from raising the money necessary to undertake these sales.

25. **Financing Fixtures.** Fixtures are property that was once movable but is now fixed to the real estate: grain silos, grain elevators, rice mills, sugar presses are all examples of fixtures. Peruvian farmers cannot finance trade fixtures -- movable property subsequently physically fixed to the real estate by offering the same fixtures as collateral. Peruvian law does not recognize that secured transaction. It treats the fixture as part of the land and

instead requires farmers to mortgage their land holdings.⁴

26. **Standing crop.** In Peru, standing crop by a farmer operating on rented land are unacceptable collateral to any private bank. In the American state of Iowa, by contrast, growing crop are a preferred collateral for bank loans. Why? Because it is cheap and simple to create a security interest in future crop in Iowa; because lenders can easily defend the priority of their claims with public registries that work well and inexpensively; and because the crop used to secure a loan in default can be seized within a few days. By contrast, in Peru, it is difficult to create an easily-defended security interest against standing crop; registries do not permit an easy perfection of claims; and it requires six to twenty-four months to repossess and sell the crop.

27. **Stored product.** Sometimes middlemen extend unsecured credit to farmers from whom they purchase. These middlemen hold inventories of production. In order to extend unsecured credit to the farmers, the middlemen must themselves get credit. In industrial countries, such middlemen get this credit by pledging their holdings of product. However, lending against inventories of coffee, or fruit, or a herd of cattle requires a floating security interest -- rare in Perú. Peruvian law does not provide a security interest that can attach to rotating inventory or to proceeds of collateral. Some Peruvian security interests continue in fruits and produces, but they are not as broad as in other countries. For example, security interests in Peru will not give creditors the right to consider their security interests as continuing against the accounts receivables or cash proceeds deposited into a bank account when the farmer or middleman sells pledged produces. Nor will allow them to collect against a tractor that a farmer acquires with that cash. As farm products rotate and get sold, creditors will lose their claim, making this type of movable property too risky to accept as collateral.

⁴ For small farmers the situation is even more difficult. In other countries with similar problems in financing movable property, small farmers can obtain credit by mortgaging their land. But in Peru, small farmers also find it difficult to obtain mortgage loans: Many small farmers in Peru do not have title to their land. For those that have titles, these are not registered in the real estate registry, and a potential lender can not file a mortgage claim until the land is registered. To make things worse, even when the registry functions well and the land is registered, Peruvian law includes many exceptions to recognizing the right of a senior mortgagee to collect, especially many exceptions are in favor junior purchasers of the land. This makes it very risky for a mortgagee to prevail in foreclosing against the land, particularly when the land belongs to small farmers and it is likely that the land titles have not followed the formalities of the law. These exceptions to a priority system by registration impede "drawing a line of certainty" about who prevails, making it very risky for lenders to accept such land as collateral.

Acopiadores, agro-processors, manufacturers, and intermediary traders of agricultural products

28. It is not only farmers who face limited access to credit because of these problems in the framework for secured transactions. Similar problems limit rural businesses. As well as exerting an independent force in retarding rural development, these defects prevent non-bank and non-financial credit channels from developing that could more naturally serve the credit needs of farmers.

29. **Financing inventory.** The problem of the lack of a floating security interest, the absence of a concept of continuation in proceeds makes it difficult for lenders to accept inventory as collateral. But in Peru, no security interest can safely attach to rotating inventory, registries do not file claims against these non licensed goods, so a lender may not know whether others have a better claim against a firm's inventory. Enforcement procedures take too long to enable creditors to collect against perishable goods. Accordingly, banks and other lenders will not accept as collateral the inventory of machinery, or processing and finished products. These legal provisions do not adequately match the Peruvian production system.

30. For example, the practice in Peruvian coffee production is to use a system of rural acopiadores to purchase coffee from the final producer, who typically is a smallholder operating on a small plot. The acopiadores will establish a working relationship over years with their producers and extend credit for fertilizer, fungicide, pesticides. The amount of credit they offer will depend on their confidence in the ability of the final borrower to repay. There is no real guarantee.

31. The amount that the acopiador can lend, however, is limited by the acopiador's own access to capital. The acopiador could, of course, get a mortgage on real estate, but the acopiador typically has few assets tied up in real estate. Rather, the acopiador has movable property as assets: tangible movable property -- trucks, inventories of green coffee -- and intangible movable property -- accounts receivable from the small producers, accounts receivable from the coffee exporters in the cities. None of this movable property can serve as collateral for a loan that would permit the acopiador to expand his operation by offering more credit to his producers. Rather, all of this movable property must be financed from the acopiador's own capital.

32. Even the use of a mortgage may not permit solving this problem. Two acopiadores for cotton reported securing taking mortgages. They used the mortgages to secure their advances to producers. In the process, they acquired mortgages on over 600 small properties of five to ten hectares -- approximately 4,500 hectares of land with a value of over \$2 million. Yet no bank would lend against that portfolio of mortgages. Why? Because using the portfolio of small mortgages requires a framework for lending against the mortgage security agreements; Peru lacks such a framework.

33. In another example, processors of fruit juice and products reported that they were unable to use their inventory of concentrate as collateral, even though concentrate is an internationally traded commodity with a ready market. Why? Because the size of containers used for the concentrate change unpredictably. Since the container size must be specified in the pledge agreement, a valid pledge agreement was unworkable. By contrast, processors of fish meal could pledge fish meal in warehouses because the practice of the trade is to store fish meal in bags of fixed sizes piled on pallets of standard weight. Of course there is no reason in public policy to favor the extension of loans to those who process anchovies and deny the extension of loans to those who process apples. Rather, these are the accidental by-products of old forms of legal drafting that, from the perspective of modern economic needs, have serious gaps.

34. All of these enterprises face the same problems as farmers in financing equipment and fixtures: essential juice extracting machines, forklift trucks, roasters all must be financed from the proprietors' own capital. To reiterate, these arise, in the case of machinery, from procedures for seizure and sale that are slow and costly; and, in the case of fixtures, from the possibility that the security in the machine will be merged with the underlying real estate.

35. Although some borrowers seemed to use their machinery, inventories and receivables as collateral, typically that financing was illusory. Rather, banks would give firms a credit line based on the firms' real estate holdings -- bienes inmuebles. And subsequent financing secured by movable property would usually be deducted from this credit line. No additional credit was granted to companies that increased their accounts receivables with more sales or that had double their movable property inventory through a more efficient production of agricultural products. Their available credit reached a ceiling in relation to their ownership of real estate, and no credit was granted based solely on their assets in movable property.

36. Few types of property besides real estate "really" serve as collateral.

37. In each case limits in using movable property as collateral for loans limited access to credit to profitable transactions and growing businesses.

38. These problems can block the flow of credit. When intermediaries like acopiadores and intermediary of agricultural products cannot borrow, they cannot pass credit down the production line to their farmer. They cannot compete with banks and other lenders. The legal system forces farmers to seek credit directly from banks. However, intermediaries often know much better than banks both their customers and the market for their products. An acopiador who extends credit to a farmer will do so with much less risk than will a bank: the acopiador working with manufacturers (empresas que habilitan a productores) in cotton or fruits, empresas exportadoras will have much more frequent dealings with the farmer and will know which farmers are more likely to pay. Moreover, they will know the equipment and product markets well enough to dispose of the farmers'

collateral with relatively little loss. Small banks cannot afford to have loan officers specialized in each branch of lending nor can they afford sufficiently geographically dispersed branches to permit the loan officers to know as many small borrowers as would the network of acopiadores.

39. Rather, the bank may find it profitable to invest in training a loan officer who can lend "wholesale" acopiadores, agricultural processors and manufacturers. Then, the latter lenders deal with farm borrowers. These loans will be larger and more easily monitored. The secured transactions framework in Peru, however, blocks lending to the farmer by these agents; and blocks the access to credit of these agents from banks. The same example can be constructed for all other intermediaries in the agricultural marketing chain.

Equipment Dealers

40. In other countries, equipment sales on credit form a lucrative business. Dealers actively compete with banks to finance equipment sales. They can be important in arranging credit for borrowers that commercial banks cannot reach easily. The equipment dealer has frequent dealings with the customer through servicing the machines. Consequently, the dealer often knows, better than a bank, the customer's reputation and likely performance as a borrower. Dealers also have a natural advantage in seizing collateral, as they know their clients well and have a good understanding of the market for their equipment. A tractor dealer, for example, can more easily seize and sell a tractor than a bank can. Moreover, when the dealer arranges the financing of a sale, the dealer makes a profit from the financing contract as well as the profit from the sale. This additional profit makes smaller loans more attractive to a dealer than to a bank.

41. But problems in the framework for secured transactions make it difficult for equipment dealers in Peru to fill this role. The typical equipment dealer in Peru has a credit line with a distributor or manufacturer. For nearly all dealers this credit line is never more than the firm's real estate holdings; it may be less if cash flow, business prospects, or other debt warrants such a reduction. While banks do accept inventories and accounts receivable as collateral, they reduce the borrower's overall credit line by the amount of the secured loan. Consequently, the dealer's own inventory of new and used equipment does not serve as collateral for additional loans. Nor does the assignment of credit sales to the bank yield loans above the existing credit line. Since the equipment dealer is unable to use inventories or accounts receivable to expand his own access to credit, his ability to offer credit for equipment sales depends entirely on his paid-in capital, embodied in cash or real estate.

42. These collateral-related problems prevent strong links from developing between banks -- the dominant financial institutions in Peru -- and potential non-bank sources of credit that are better suited to lend to farmers and small and medium-scale enterprises.

43. Dealers also have credit lines with their manufacturers. Manufacturers typically offer a credit line to a dealer based on the dealer's real estate holdings. Manufacturers will directly finance farm equipment purchases only if the ultimate purchaser owns real estate. This leaves the dealer without credit financing for his inventory of used equipment. Accepting used equipment is crucial in selling new equipment. Purchasing used equipment provides important investment opportunities for smaller and less wealthy farmers. However, the terms for financing are typically quite short -- one or two years -- because the dealer cannot get credit to refinance the used machines sold on credit.

44. In many countries, dealers can themselves borrow to extend this credit. Movable property can secure such loans in two different ways. First, the dealer's inventory of movable goods can serve as collateral for loans. Banks and financial institutions can extend credit to the enterprise to finance these inventories.

45. Second, in many countries dealers can also obtain credit to make further sales by rediscounting or selling the loans they generate through their credit sales. In Peru, however, equipment dealers reported that no practical way existed to sell or rediscount these generated loans. That was so even if the dealer offered the purchaser of the note recourse upon default. The total credit available to them is determined by the value of their real estate holdings; total credit was unrelated to their holdings of inventory. Consequently, businesses must finance both their inventories and any dealer-financed sales out of their own capital.

46. Importers of fertilizers, pesticides and retail agro-business in Peru reported similar problems. They cannot finance their credit sales using their accounts receivable as collateral. While banks may appear to take the assignment of such documents as collateral, they actually deduct any loan amounts from the enterprises's overall credit line, which is based on its real estate holdings. No additional credit is actually supplied; the documents have no standing in and of themselves as collateral for loans, because Peruvian law lacks of security interests in intangible rights to receive payment.

47. In other countries, such accounts receivables constitute adequate collateral, that permit banks and capital markets to ultimately finance large amounts of small unsecured loans. In markets where these financing techniques are well established and the legal and regulatory infrastructure is in place, refinancing are routinely undertaken in the face of considerable higher risks than those encountered in the Peruvian firms that were interviewed for this paper. In the United States, for example, consumer credit cards yielding 19 to 21 percent annually can have non-performance rates as high as 4 to 5 percent. Yet these high interest rate, low-performance accounts have a ready market, both to sell and to secure loans. This experience shows that under the right circumstances even small loans with poor performance can be an important feature of bank lending. The restrictions observed on Peru on lending against accounts receivable of excellent quality (zero non-performance) arises from problems in the legal and regulatory framework that are discussed below.

NGOs Lenders.

48. Several NGO lenders are undertaking programs in Peru based, broadly, on solidarity group lending models. In solidarity group lending, an old tradition in the Andes, several borrowers cosign for a loan. Other institutional features may be used to promote the solidarity of the group, typically associated with the broader social objectives of the NGO.

49. Experience with such NGOs has indicated that internal management and incentives are crucial in determining their success. Beyond these issues, however, certain key features of the legal and regulatory environment will critically influence their operation.

50. First, while NGO lenders may use many informal methods to guarantee their collection, these informal methods share the qualities of non-legality or illegality. That makes it difficult for formal sector institutions, like banks and capital markets, to link up with the informal institutions and extend credit to them. For example, an NGO may use self-help repossession illegally to repossess machinery that it finances. And, by following such illegal procedures, the NGO may achieve good rates of loan performance. But the NGO will have difficulty using that portfolio as collateral for a bank loan, because a bank will not want to use illegal collection methods. Even if it were willing to, it would have to agree with a supervisory judgment that the loans were not legally collectible and accept the consequences for provisioning. The bank could not assert to the bank examiner that the bank planned to use illegal methods to collect the portfolio. Similar problems arise with notes that include the guarantees of minors or illiterates, which will not be enforceable in court.

51. Second, the NGOs own loan performance can be improved with improvement in the legal framework. Working credit bureaus will help them better judge risk. More rapid and flexible systems for repossession and sale of collateral will permit financing larger individual loans than will the group lending system.

52. Of course these NGO lenders can function without the legal and regulatory changes noted here. But making them into sustainable operations with private financing and permitting them to expand to their full potential in Peru will require the changes set out here.

53. **Private Banks.** With a few minor exceptions, private banks in Peru will not extend credit for movable property unless the borrower presents evidence of ownership of real estate or a co-signer that can produce such evidence.

54. Banks do not accept as collateral accounts receivables. For example, private banks would not lend to a financial company by taking as collateral its accounts receivable. Peruvian law does not provide for a security interest in a group of accounts that rotate or

not embodied in a negotiable instrument. Accordingly, the banking regulations do not recognize the accounts receivables as an acceptable form of collateral for a loan.

55. Banks accept the warehouse receipt as collateral only against non-perishable and homogeneous goods, like coffee, cotton and an fish meal. But they will not accept warehouse receipt for inventory that needs to rotate, like perishable fruits and vegetables, nor machinery that a borrower needs to use.

56. Banks will not lend to intermediary lenders such as retail businesses and manufacturers by accepting as collateral the mortgages and pledges that these firms would take from farmers because.

III. The Cause of the Secured Transactions Problem

57. It is easy to show that Peruvian farmers and businessmen cannot get credit secured by movable property. How do we know, though, that this problem arises from the legal and regulatory framework? How do we know that the source doesn't lie elsewhere? Basically, because the elements of the story traced to legal and regulatory roots is well-documented and provides a consistent economic underpinning to explaining why lenders do not accept movable property as collateral; and because alternative explanations are less satisfactory. This section looks at each.

A. Legal, regulatory, and institutional roots

58. Economics is premised on the broad assumption that people are rational enough to make themselves as best off as they can be subject to constraints that they cannot change. So the first step in understanding why Peruvian lenders will not take movable property as collateral or sell equipment on credit is to ask them. The answer, invariably, is that such collateral is too risky.

59. This paper carefully investigates that explanation. It finds that under the framework for secured transactions in Peru, making loans against movable property is indeed far more risky than in North America or the United Kingdom, where such loans are far more common.

60. It finds this risk at each stage of a secured transaction:

Creation: is expensive, cumbersome, and fails to envision instruments to cover transactions of key economic importance

Perfection: those taking security interests cannot be certain of their priority, cannot easily discover whether collateral has already been pledged, and cannot be certain of the legal standing of their own claims

Enforcement: requires lengthy and expensive judicial action which takes far longer than the economic life of much movable property offered as collateral, making the property valueless as collateral.

61. These points are spelled out at length in the following chapters. Together, they support the view that a rational lender would not take movable property as collateral in Peru.

B. Other explanations

62. Many other explanations have been offered to explain the lack of credit for movable property in particular and to small farms and small businesses in general. This section sets out some of those explanations, discusses their advantages and shortcomings, and relates them, where appropriate, to problems in the secured transactions framework.

Quantitatively the bottom line is clear: in the United States, a borrower financing machinery, offering no collateral other than the machinery, will pay about 14.5 percent on the loan; in Peru, the same borrower will pay about 40 percent. Of this 25.5 percentage point difference, about 6.5 percentage points arises from greater macroeconomic risk in Peru compared to the United States; the remaining 19 percentage point difference arises entirely from problems related to collateral. This section explains that calculation.

63. **Macroeconomic concerns and high bank intermediation margins.** Equipment financing, for new and used tractors, for example, where the loan is secured only by the tractor and the borrower owns no real estate, is available in the United States for between 10 and 15 percent per year. There are no such loans in Peru given by private lenders, except for warehouse receipts and automobiles. For other equipment, such loans are treated as unsecured. The interest rates on such unsecured loans runs about 40 percent per year. The difference amounts to about 25 percentage points per year in Peru on dollar-denominated loans.

64. Three factors combine to create this difference: macroeconomic uncertainty, high bank spreads, and collateral-related risk. We can decompose these elements quantitatively to understand their importance.

65. **Macroeconomic risk.** The use of the dollar denominated interest rate in Peru gives an easy benchmark for the quantification of macroeconomic risk. The dollar interest rate in the United States contains no risk associated with currency devaluation: a US dollar-denominated bond is a promise to pay principal and interest in US dollars; as the US government has the legal right -- alone in the world -- to print dollars, the probability of being unable to convert dollar bonds into dollars is least in the United States. Even a country with impeccable "fiscal credentials" -- no matter how large its budget surplus or current account surplus -- cannot match the security of the promise of the United States to convert its own dollar-denominated debt into dollars.

66. The Peruvian government must "work" to pay its dollar-denominated debt -- it must raise taxes in soles and convert those soles to dollars. Unlike the United States, the credibility of the promise of the Peruvian government to have the dollars when it is time to service its dollar-denominated debt depend both on the fiscal performance of the Peruvian government and on the likelihood of being able to convert these soles to dollars. The latter, in turn, will depend on export competitiveness, the ability to contract imports, and the willingness of other foreign lenders to lend to Peru. These are complex issues and the bond-buying public expresses its collective concern about these issues by agreeing to lend

to the Peruvian government only at higher rates of interest than it is willing to lend to the United States government. Recently, with interest rates on short term debt at 5.5 percent in the United States and 12.0 percent in Peru, that difference amounted to about 6.5 percentage points. (See Table 1).

67. Higher bank spreads and the difficulty of collecting against real estate mortgages. A second element in explaining high Peruvian interest rates arises from higher bank spreads between the lending rates and the cost of funds as well as problems in the framework for using real estate as collateral. In the United States, for example, recently the mortgage interest rate was 7.9 percent. In contrast, in Peru recently the mortgage interest was 17 percent. Of that 9.2 percentage point difference, 6.5 percentage points arose from the greater macroeconomic risk in Peru. The remaining 2.7 percentage point arises from higher bank spreads and difficulties in collecting against mortgages.

68. Collateral risk. The final element in explaining the higher equipment lending rates in Peru arises from the collateral risk we are investigating here. In the United States, the rate of interest on new car loans was 9.6 percent while in Peru the rate was 24 percent; the difference in interest rates amounted to 14.4 percentage points. Of this difference, 9.2 percentage points were caused by greater macroeconomic risk, the general difficulties of collecting private debts, and greater bank spreads. The remaining difference of 5.2 percentage points arises from the greater difficulties of using automobiles as collateral in Peru as compared to the United States.

69. Loans secured by other types of equipment are treated as personal loans; where U.S. borrowers pay rates of 14-16 percent, Peruvian borrowers pay rates in the neighborhood of 40 percent, if they are offered loans.

70. In explaining the total extra interest cost of about 25.5 percentage points that investors in Peru would face compared to their North American counterparts, therefore, about 6.5 percentage points arise from macroeconomic uncertainty, and the balance arises from the extra risk of equipment lending in the Peruvian framework for secure transactions. Put differently, about three-quarters of the problem of high interest rates facing Peruvian investors is a problem that arises from the laws and legal procedures that govern lending against movable property.

Table 1: Explaining High Interest Rates for Loans in Peru			
	United States	Peru	Difference
1. Effect of Greater Macroeconomic Risk in Peru: <i>[There is no risk that the U.S. government will be unable to pay its bonds in dollars, because it has the legal monopoly on printing dollars. The government of Peru must get its dollars by raising taxes or cutting spending. These are politically difficult actions and lead to perceptions of macroeconomic risk. The difference between the U.S. interest rate on dollar bonds and the Peruvian interest rate on dollar bonds is entirely macroeconomic risk.]</i>			
Government borrowing rate in dollars 3-month dollar-denominated notes	5.5%	12.0%	6.5%
2. Effect of Higher Bank Intermediation Spreads and Greater Difficulty in Collecting Against Real Estate Collateral:			
Mortgage Interest Rate	7.9%	17.0%	9.1%
3. Estimated Impact of the difference in the framework for secured transactions: <i>[Differences in macroeconomic risk and intermediation cost apply equally to loans secured by real estate and loans secured by movable property. In the United States, loans secured by movable property have interest rates close to the interest rates on mortgages; in Peru, banks do not make loans secured only by movable property and non-bank lenders charge rates of about 60 percent]</i>			
New Car Loan	9.6%	24.0%	14.4%
Equipment Loan	14.5%	40.0%	25.5%
Personal unsecured loan	15.8%	40.0%	24.2%

Source: U.S. data for 1995 (annual average) taken from **Federal Reserve Bulletin**, April 1996, tables 1.35, 1.53, 1.56; Peruvian data are from wire services carrying Peruvian data. Rates for loans secured by movable collateral based on evidence given during interviews.

71. **Banks lack interest in making small loans.** Some have asserted that credit is unavailable to farms and small businesses because banks are reluctant to make small loans because of the cost of administering them. Taking off from this point, some lending operations of multilateral lenders have placed the cutoff for small loans as high as \$100,000. Could it be that loans secured by movable property tend to be small and that this, rather than problems with movable property as collateral, explain the failure of banks to lend for movable property?

72. Several difficulties beset this explanation. First, the definition of small loan is quite vague. Certainly, in the United States, where labor costs are high, banks can profitably process individual credit lines for even under \$1000. Making personal loans of \$10,000 is a hotly competitive business, as even a walk in the neighborhood World Bank headquarters in Washington will attest. Making car loans in the United States in amounts ranging from \$8,000 to \$20,000 is an

enormous business. By contrast, in Bolivia, with a similar framework for secured transactions as Peru, and with 75% of its bank loans less than \$10,000, multilateral lender's credit lines for equipment fail to disburse in mining, in agriculture, and in small business. It is difficult, therefore, to believe that high "transaction costs" are a major source of bank reluctance to make loans of this size. the risk of movable collateral.

73. Second, loans for movable property are not, per se, small. Examples abound: the sugar cane press exceeds the value of the farmer's house; banks will lend for the house and not for the press. The fruit in the refrigerated warehouse exceeds the value of the warehouse; banks will lend for the warehouse and not for the fruit.

74. Moreover, movable property comprises more than equipment. It includes inventory and intangible personal property, like accounts receivables. As was discussed earlier in the chapter, a bank might not be interested making a loan for \$89.95 for a portable drill for a farmer. But it certainly would be interested in a portfolio of 100,000 such accounts receivable or equivalent credit card debt; or a loan to finance the inventory in a warehouse containing 100,000 such drills. That these loans are commonplace in North America and the United Kingdom and unknown in Peru arises not from the proclivities of banks but from failings in the framework for secured transactions. Indeed, the very same multinational banks that will make such loans in the United States, Canada, and the United Kingdom will not make them in Peru; and, if asked why, they will identify the risk associated with the instrument.

75. Third, the credit structure includes far more than banks. It includes non-bank financial intermediaries, like finance companies, factors, pawnshops, and NGO lenders; it includes non-bank non-financial creditors like warehouses, dealers, wholesalers, and feed lot operators. All of these economic agents face problems in giving and getting credit even though, in many cases, their niche in the market exists precisely because they are willing to give small loans.

76. Finally, if "small loans" mean loans under \$100, it is important to note that in a well-functioning financial system, banks do play a key role in delivering such small loans to small borrowers. They do this both by making small loans directly and by refinancing the loans of other institutions, including NGOs. Banks in industrial countries commonly issue credit cards with credit lines as small as the maximum lending limits of NGOs lenders. They refinance such small loans with securitized commercial paper issues that bundle thousands of such small loans and refinance them in the commercial paper market. Banks in industrial countries refinance the loans made by countless shops, wholesalers, fertilizer dealers and other enterprises that routinely extend small amounts of unsecured credit to small borrowers. They perform the same function in refinancing the loans extended by finance companies and pawnshops. Sometimes they take direct positions vis a vis these institutions; sometimes they guarantee the commercial paper issues of these institutions. The inability of Peruvian banks to play this role arises not from the small size of the ultimate loan. Rather, it follows from the difficulties outlined earlier in using such small accounts as collateral, registering claims against them, and regulating loans made against such collateral.

77. **Bank regulations are excessively restrictive** Some explain the absence of credit for movable property and the insistence on mortgaging land or giving evidence of land ownership as a result of excessively strict bank supervision and regulation. We found no evidence, however, that private Peruvian banks wished to make loans secured only by movable property; rather, except for a few banks making automobile loans and financing coffee warehouse receipts they uniformly regarded them as too risky. No bank credit manager stated that the bank would be willing to make such loans if permitted by the Superintendent of Banks.

78. Indeed, Peruvian bank regulations treat loans secured by movable property no differently from unsecured loans. Good bank regulations will reflect the legal realities of collection against different types of clients and different types of loan guarantees. The regulatory treatment of movable property that serves as collateral broadly conforms to the reality of debt collection in Peru.

79. Peru has only limited opportunities for changing bank regulations without substantially increasing the risk to the banking system unless, at the same time, changes occur in the Peruvian legal, regulatory, and institutional framework for secured transactions. Only changes in that framework will permit changing the banking regulations without raising the risk to the banking system.

80. In the short term, regulatory improvements of some security interests may lay the ground for more tailored banking regulations that would permit some loans to disburse safely. These opportunities require further research and are discussed in chapter VIII]

81. **Insufficient Savings.** Some have asserted that low savings in Peru limit the funds available for investment in movable property. They note that if those with the investment opportunities in movable property saved more, then they could invest more. Of course, for many in Peru this is idle advice. First, many of those with investment opportunities have no income from which to save. Mainly, the rich can save today in Peru. Those rich people that can save, have loose investing in Peru because they face the same collection problems on their loans that the lenders face.

82. Indeed, if domestic savings rose generally, then domestic savers without their own opportunities to invest in movable property would have just as much concern over lending their savings without acceptable guarantees as would the banks who now intermediate these funds. Financial markets improve overall economic efficiency, in part because they transfer claims from savers to investors in ways that allocate society's savings to the investments with the best combination of risk and return. The absence of acceptable collateral in Peru raises the risk to investments in movable property and makes savers less willing to take these investments.

83. A similar phenomenon arises in Bolivia, where the framework for secured transactions is similar to that of Peru. There, credit lines of the multilateral development banks lie undisbursed. If the only issue were insufficient savings, then borrowers would draw on foreign savings in the form of such credit lines to finance their projects. Rather, these loans remain undisbursed because

no well-functioning system exists that permits moving domestic and foreign savings into the hands of investors who cannot present acceptable collateral.

84. Overall, internal financing of investment is not a very effective solution to financing problems, especially for small farms and businesses. It is particularly difficult for such operators to increase their savings. Consequently, they can self-finance their own investments only at a very slow rate. Even farms and businesses with excellent investment opportunities can take advantage of them only at the rate at which they can accumulate savings. This limits the rate of growth of the economy below what it could be. Moreover, it limits growth in a way that bears heavily on the most able operators of farms and businesses who happen not to have inherited wealth that is liquid or embodied in real estate.

IV. The Gain to Peru from Reforming the Framework for Secured Transactions

85. Peru has reformed rapidly. The agenda for future reform is full: it leads inescapably to asking how important in the policy agenda is the reform of secured transactions to the government, to the farm community, and to Peruvian business in general.

A. Qualitative Issues

86. **Efficiency in allocating capital.** The problems that arise for lenders who might take movable property as collateral lead lenders to regard loans secured by such collateral as no less risky than unsecured loans. This leads lenders to charge higher interest rates for such loans and to reduce the quantity of such loans that they offer. Whereas in North America, farms and businesses might face similar interest rates for loans for movable property and real estate, businesses in Peru face much higher interest rates for movable property. That leads Peruvian farmers business operators to reduce the amount of movable property that they use in the course of doing their business.

87. These problems with undertaking secured transactions affect not only the volume and price of investment, but also its allocation. For landless Peruvian farmers and businessmen, a credit system linked rigidly to real estate limits development. As a business expands, for example, its sales will increase. This higher volume of business may or may not require more physical space, but it will certainly require larger inventories. If inventory cannot serve as collateral and the business has already borrowed the maximum against its real estate, it must finance this additional inventory out of its own capital. The same business can borrow to expand the size of its physical plant, using the expanded real property as collateral. Diverting investment away from inventory and toward physical plant, however, is less economically valuable than encouraging capital growth in potentially marketable inventory. In agriculture, expanding farm profits often involves increasing yields per acre by using more machines or livestock on a given amount of land. Under such conditions, optimal investment in machines or livestock increases relative to investment in land. However, when machines and livestock cannot serve as collateral and lenders will extend

credit only for more land, farmers have incentives to invest more in land and fixed assets than in potentially more productive livestock and machinery.

88. This, of course, is efficient in the framework of the existing Peruvian laws and legal framework: That is, behaving this way is the best that Peruvian farmers can do. The difficulty is that in North America the same capital will produce more output, because fixed capital and labor are combined with more movable property there. Productivity per worker gains when farms and businesses can profitably hold larger inventories, use movable equipment, and install fixtures. Changing the framework would permit an increase in output.

89. **Efficiency in the allocation of savings.** Most individuals want to save a different amount from what they want to invest. This is natural in a free market economy. Capital markets exist to permit cheap and efficient means of shifting savings from savers to investors. But savers will demand safeguards to guarantee their funds. If investing borrowers cannot provide such guarantees, then the savers will not permit them to use their funds. Reducing the riskiness of this collateral will permit more savers to lend funds to borrowing investors. Therefore, the total volume of investment will rise.

90. In each of these examples, collateral restrictions force the businessmen and farmers to finance expansion of their growing businesses out of their own capital because these enterprises have limited access to borrowed funds. A secured transaction system that directs credit away from more rapidly growing businesses and toward slower growing businesses is not the most system that will promote the most economic growth.

91. That difference in interest rate could be reduced in a system that efficiently addressed these problems in secured transactions. In the United States, for example, rates of interest on loans for a wide array of equipment, cars, and other movable property run 1/2 to 1 percentage point above the mortgage interest rate. In the United States, nearly 40 percent of the country's credit is secured exclusively by movable goods.

92. An efficient collateral system in Peru would probably reduce the cost of financing movable equipment to 16 percent to 21 percent with improvement in macroeconomic outlook. Once Peru's macroeconomic advances were more generally perceived, these rates could fall to the range of 10 percent to 15 percent. Loans for potentially well-secured movable property loans, such as homogeneous products stored in warehouses could be financed at rates a few hundred basis points over the government borrowing rate. The amount of movable property so financed would increase substantially, since under the existing system such credit is offered only to landowners.

93. **Equity, poverty, and access to credit.** Lack of access to credit affects all Peruvians -- even the wealthiest farmers and the most profitable companies in Peru could gain from innovations that permitted cheaper financing of equipment and inventories. However, the burden of an inadequate framework for secured transactions is felt most heavily by those farmers who work rented land, or who sell their services and do not own land, and by small rural business that supply inputs to these farmers. For them, an inadequate framework for secured transactions does

not mean that they get less credit; it means that they get no credit at all. Moreover, other lending agencies, including NGOs, that attempt to make unsecured loans will find that their ability to make loans is vastly constrained.

B. How much does this matter?

94. Reforming the framework for secured transactions would expand credit availability for movable property and lower the interest rate. When such a change affects something potentially as large as 1/3 of the capital stock, the overall economic impact is important. Under a variety of simplifying assumptions, it has been estimated that such a reform could raise Argentine GDP by 6% to 8%. Using a different technique, a similar potential gain was derived for Bolivia, a country different in many respects from Peru but similar in its laws for lending against personal property. For Bolivia the gain from an improved framework for secured transactions, estimated in a different way from that of Peru, amounted to 3% to 9% of GDP. Finding a similar relative impact in the face of similar laws, while using different techniques to assess impact and in the face of substantial other differences in economic structure increases the confidence that may be attached to the quantitative findings.

95. In absolute terms, that gain for Peru would amount to several billion dollars. By contrast, the options for reform set out in this paper could be studied and implemented for under \$1 million and even a complete overhaul of the registries would cost under \$10 million. These figures would support the view that these reforms merit consideration.

V. Peruvian Framework for Secured Transactions: Overview

96. The different economic problems that surround collateral arise from problems in the laws that govern *security interests* in Peru. This chapter examines this area of the law, identifying the general characteristics of a *security interest* system and then focusing specifically on Peruvian law.

97. **Security interests.** How can parties secure a loan? Broadly speaking, they can do this by creating a *security interest* against a debtor's property. Under the law, a security interest affects a specific property of the debtor to the satisfaction of a debt. With security interests, parties may choose what property to encumber allowing them to leave property unencumbered or to encumber property with other parties. In a well-functioning secured transactions legal framework, in case of default or if property is sold or exchanged, a creditor with a security interest (secured creditor) has priority over junior secured creditors, and over the claims of creditors without a security interest (unsecured creditors).⁵

98. What happens when there is no security interest? Without a *security interest* a creditor has only a general claim against a debtor's property. The creditor may collect against any property of the debtor, but other parties may have a better claim in the debtor's property. Thus, credit granted unsecured, like signature loans, is usually smaller and more expensive than that granted secured with collateral.

99. The Peruvian secured transactions framework does not comply with these basic elements. Many exceptions undermine the priority of security interests in collateral.⁶ Such exceptions

⁵ If the secured creditor's security interest is not satisfied by the sale of the collateral, that secured creditor also retains a general, unsecured claim against the debtor's other property for the deficiency.

⁶ For example, labor claims and tax obligations of any type enjoy legal preference, before any other obligations. The Constitution of 1979 established in article 49, that "The payment of remunerations and social benefits of workers in all cases takes preference over every other obligation of the employer." A similar norm has been adopted in article 24 of the new constitution. Similarly, the Tax Code (Código Tributario adopted by *Decreto Ley 25859* published November 6, 1992) establishes in article 6 that the tax creditor will have preference over the taxes due after notification of the tax debt.

When real estate serves as collateral the second part of article 2022 of the Civil Code provides that if rights of different nature conflict, like a purchaser and a mortgagee, the first to register his security interest rule would not apply. An expert scholar recently noted: "The last part of the article indicates that when there is an overlap between a real right (security interest) and a personal right (contract right), preference will be given to the one that holds a right according to contract law, like if the laws for registration to this effect did not exist. (La ultima parte del artículo indica que cuando se produce un enfrentamiento entre un derecho real y otro personal la preferencia será otorgada a quien tenga derecho conforme a las disposiciones del derecho común, como si el derecho registral para estos efectos no existiera. (Fernando Cantuarias S., "La función Económica del Derecho: A propósito de los Derechos de Prenda e Hipoteca," *El Derecho Civil Peruano*, Pontifica

destroy the main reason for using security interests. This severely limits access to credit in Peru: In many instances, taking a security interest will be the same as not taking it. Consequently, secured loans will be made under the more expensive terms provided for unsecured loans. For example, in Peru, a loan secured with equipment or a car, carries the same interest rate and financing terms than an unsecured line of credit for the overdraft of a checking account. In countries that provide for an appropriate secured transactions framework that would not be the case. Loans secured with a security interest in a car or equipment will carry longer maturities and lower interest rates than unsecured loans.

100. Fragmented Peruvian Framework of Security Interest. Unlike modern secured transactions frameworks, Peru has several laws that govern several types of security interests: A commercial and a civil pledge set out a basic framework,⁷ and specific pledge laws govern pledges in different kinds of movable property. These include the pledge of securities (*prenda de acciones*),⁸ the pledge of accounts (*prenda sobre créditos por cobrar*),⁹ the agrarian pledge (*prenda agrícola*),¹⁰ the industrial pledge (*prenda industrial*),¹¹ the mining pledge (*prenda minera*),¹² and the pledge of warehouse receipts (*warrant*).¹³ Security interests in immovable include the mortgage in real estate,¹⁴ ships, aircraft,¹⁵ mining concessions¹⁶, rural land,¹⁷ peoples

Universidad Católica del Peru, Fondo Editorial 1993, at pp.53-81, citing: Exposición de Motivos Oficial del Código Civil -- Registros Públicos, El Peruano, November 19, 1990, p. 21.).

⁷ COM.COD., Art. 315.

⁸ *Ley de Sociedades*, promulgated by Legislative Decree 311, published November 14, 1984, art. 111.

⁹ Governed both by the Civil Code and by the *Ley de Títulos Valores*.

¹⁰ Law 2420, which creates the Registry of Agricultural Pledges (*Registro de Prenda Agrícola*) was promulgated December 13, 1916. The Legislative Decree 653, *Ley de Fomento al Sector Agrario*, published August 1, 1991, also regulated this material.

¹¹ The *Ley General de Industrias*, Law 23407 published May 29, 1982, regulates this special pledge.

¹² Conforming to article 1 of the first title of the General Law of Mining (*Ley General de Minería, Texto Unico Ordenado*, approved through the Supreme Decree 014-992-EM, June 2, 1992), mining activities include all that is related to the use of mineral land and underground substances within the national territory, including the maritime sovereignty, with the exception of petroleum and other hydrocarbonates, deposits of guano, geothermic (*geotermicos*) recourse and mineral waters.

¹³ Law 2763, *Ley General de Almacenes*, June 27, 1918.

¹⁴ In accordance with article 885 of the Civil Code, ground, underground, above ground, the ocean, the lakes, the rivers, the *manantiales*, currents of water, mines, quarries and deposits of hydrocarbons, boats and planes, dams and docks (*los diques y muelles*), *los pontores*, *plataformas y*

mortgage (hipoteca popular),¹⁸ and the antichresis.¹⁹ Finally, Peruvian law provides for hybrid security interests in movable and immovable property that include the trust, the financial lease, the sale with reservation of ownership (venta con reserva de propiedad),²⁰ and the right of retention²¹

101. These many security interests laws contribute conflicts of priority that increase a creditor's risk of collecting. Also, it is not possible for many types of security interests to cover all possible types of property and transactions. Thus this fragmented system leaves many economically useful transactions without any means of security. These problems greatly diminish the use of property as collateral for loans.

102. More specific problems arise from this framework. They include problems in the three stages of a security interest:

- Creation, where a creditor will secure a loan by establishing a security interest in a specific property (the collateral).
- Perfection, where the creditor will set his priority in that collateral, and

edificios flotantes, las concesiones para explotar servicios públicos and minerals, stations and train route and the material affected by this service, rights to movable property unable to be inscribed in the public registry and whatever else that the law gives this quality, are all immovable property.

¹⁵ *Ley de Aeronáutica Civil*, Law 24882, published July 30, 1988.

¹⁶ *Ley General de Minería*, Legislative Decree 109, published June 13, 1981.

¹⁷ The creation of the Registry of Rural Property (Registro de Predios Rurales) as part of the Registro Predial, has permitted that the procedure for the filing of the mortgages on predios rurales be very simple.

¹⁸ This mortgage applies to real estate in new towns and in poor neighborhoods. Also a registered possessory right to land may serve as collateral.

¹⁹ Civil Code, articles 1091 to 1096.

²⁰ See Civil Code art. 1583, whose provisions are extended to a secured transaction disguised as hire-purchase agreement (COD.CIV., art. 1585).

²¹ Some contracts give to one party the right to withhold property (derecho de retención). *La retención* is the guarantee by which the creditor has the power to keep the debtor's property, movable or immovable, if his credit is not sufficiently secured. This right can be exercised in cases as provided by law or when there is a connection between the creditor and the property which he retains. The creditor must petition in court the attachment, seizure and sale of the property. The property must be sold in a judicial auction and it may not be adjudicated to the creditor. This right is extinguished with the payment of the debt or when the debt is sufficiently secured.

- Enforcement, where, upon the debtor's default, the creditor will seize and sell the collateral to extinguish the outstanding loan amount.

VI. Problems in Creating Security Interests

103. As the previous section discussed, problems in the creation, perfection and enforcement of security interests limit their use in Peru. This section discusses the problems that arise when the law does not permit the creation of a valid security interest that corresponds to the underlying economic transaction.

A. Restrictions on Who May Enter into Secured Loans

104. Access to credit is best served when the law grants the most liberty to citizens in creating security interests. In Peru, however, several laws limit the use of security agreements. For example, the trust: a useful device to secure loans because the debtor transfers ownership of collateral to a trustee who may sell the collateral without court intervention. Through this, the trust may avoid lengthy and costly court procedures.

105. However, in Peru, only banks may serve as trustees.²² By requiring this, Peruvian law prevents non-bank lenders from using the trust. Ironically, the limitation may also limit banks from using the trust. If a bank acts as lender, it would need to be the beneficiary of the trust to receive any proceeds of the sale of the collateral. However, in a trust, a beneficiary cannot be the trustee of the trust. So, one bank must serve as trustee for another. Many banks will find this a very troublesome arrangement.

106. In other countries, any person can serve as trustee. Under such systems, non-banks serve as trustees, permitting bank lender to become beneficiaries of the trusts that secure their loans. In the most common real estate loan in Washington, D.C., the trustee can be any person and the bank lender is the beneficiary of the trust. The restriction in Peru may explain why the trust has not developed as a means to secure loans.

107. Like the trust, the financial lease provides faster enforcement procedures: the lessor has ownership to the collateral and may quickly obtain a court order to seize it. In Peru, however, the Banking law requires that the Superintendency of Banks supervise leasing companies²³ while the Leasing law requires that lessors be merchants. These conditions raise taxes and the cost of compliance and account keeping²⁴. These higher costs make leasing more expensive for

²² Ley General de Instituciones Bancarias Financieras y de Seguros, Art. 315.

²³ The 2nd. paragraph of the Disposiciones Finales of the Ley General de Instituciones Bancarias Financieras y de Seguros, provides: "Las disposiciones de la presente ley no alcanzan a las empresas de arrendamiento financiero y a los almacenes generales de depósito en los que los bancos y financieras carezcan de participación accionaria. Sin embargo, unas y otros están sujetas a la autoridad y el control de la Superintendencia."

²⁴ See Ley de Arrendamiento Financiero (Decreto Legislativo 299 of July 29, 1984, and Decreto Supremo 559-84-EFC, of 12.30.94).

businesses. This can exact a high price in access to credit. For example, equipment dealers have frequent dealings with their clients. Because they know their clients better than would a bank, the risk of their lending to these clients is lower. Moreover, since they are in the business of selling the equipment, they can repossess and resell the collateral at a lower cost than can a bank. This gives the business a comparative advantage in being the originator of the financial lease. Indeed, in countries that allow anybody to lease, banks refinance the dealers' portfolio of leases, rather than lease themselves. Given these restrictions in Peru, it is not surprising that leasing financing has scarcely developed.

B. Limits on What Property May Serve as Collateral

108. In many legal systems, most movable property and fixtures can serve as collateral. This includes tangible property, such as equipment and inventory, but also intangible property, such as rights, instruments, general intangibles, chattel paper, and accounts receivable. In Peru, it cannot.

109. **Heavy Equipment and Installations on Real Estate (Fixtures).** Fixtures are equipment that is physically fastened to real estate -- like boilers, air conditioning compressors, or printing presses. The law facilitates enterprise financing when all fixtures may serve as collateral. Independent of the principal asset and even if removing the fixture will damage the principal asset. In Peru, however, a "component part" (a part integrated with another)²⁵ may not be subject to a security interest independent of the "principal" asset. For example, to use a grain elevator or a green house as collateral, a farmer would need to mortgage the real estate to which this equipment was attached. Nor would dealers in fixtures sell them on credit to the farmer: the credit-sellers would not be able to retain a security interest in the fixture once the fixture was attached to the real estate. Consequently, if the farmer had already mortgaged his land, he most likely could not obtain financing secured by these fixtures.

²⁵ Unlike older civil codes, the Peruvian Civil Code distinguishes fixtures between those that are a "component part" (parte integrante) and those that are a mere "accessory" (accesorio) of an asset (Código Civil [C.civ.] Peru, arts. 887-889). Whereas a "component part" may not be separated without "destroying, damaging, or altering" the principal asset, an "accessory" may be so separated.

110. Similarly, although Peruvian law allows parties to encumber a fixture that is an "accessory" (accesorio), it requires the consent of the owner of the principal asset.²⁶ So for example, in Peru, a store must seek permission from its landlord or its mortgagee to offer a pledge in a refrigerator. This requirement blocks the ease of using equipment fixtures, such as heavy equipment, as collateral for loans. Landlords and mortgagees have no incentive to give up their interests in favor of other lenders; rather they would prefer to see their existing asset improved or the security for their mortgages increased. Therefore, in practice, the requirement limits the sources of financing available to borrowers.

111. **General Intangibles, Chattel paper.** Peruvian law places other limits to property that may serve as collateral through its incomplete framework of fragmented security interests. Peru provides for many security interest laws that govern only specific property. Each pledge law states the property parties may pledge. However, it is logically impossible to list all categories of property. Consequently, many items are left out.²⁷ For example, the non-possessory pledge laws do not seem to include patent and trademark rights, intangible rights to receive payments, computer software, electricity, gas, water, pledge contracts, cash, or monies deposited in bank accounts²⁸. Of these, chattel paper (like pledge contracts) and accounts receivables become crucial for linking smaller or informal lenders with formal sector lenders (discussed below).

²⁶ The "principal" asset.

²⁷ The problem resembles the issue of continuity in mathematics. It is possible to "list" all the numbers between zero and one by using the description "all the numbers between zero and one". However, it is not possible to specifically enumerate all the numbers between zero and one, however. This can be seen readily by noting that for any two numbers listed between zero and one, another number between those two can be immediately computed. The drive for specificity in the description of material that can be pledged will inevitably leave gaps; the more specific the law, the more economically important the gaps are likely to be.

²⁸ Non possessory pledges refer to those that allow the debtor to retain possession of the collateral.

C. Limits to Financing Inventory with Security Interests that Float and Continue in Proceeds

112. For most businesses, inventories form an important fraction of their capital and, therefore, of their financing requirements. Where systems of secured transactions facilitate such financing, they do so by giving a security interest that *floats* and may attach to any movable property that satisfies a general description. Security interests that *continue in proceeds* attach to any property that replaced the original collateral, and to the proceeds of those proceeds. This means that a car dealer, for example, may give a bank a *security interest* that floats on his inventory of motor vehicles. The dealer is there do business: sells one car, and receives in exchange a cash down payment, an old car, and a check for the balance. All these would be *proceeds* of the inventory collateral of motor vehicles. If the dealer defaults, the bank's security interest *continues* against the cash, the old car and the check, so it can enforce its security interest by seizing and selling any of them.

113. Such transactions are very difficult in Peru. Security interests require precise identification of the collateral.²⁹ Since parties may not describe the collateral in general terms, the security interest cannot float. Moreover, security interests continue only in "*fruits*"³⁰ and "*products*" of the original collateral.³¹ These are narrower ideas than *proceeds*. For example, monies received from the sale of a pledged property and deposited in a bank account would not be considered subject to the pledge.³² Nor would a truck bought with that money. These problems increase the risk of collecting a secured loan.³³ The consequence is less financing of inventories.

²⁹ Article 1058 of the C.civ. requires, for the pledge to attach, that the debtor have ownership or be authorized to deal with the collateral, and articles 1061 and 1062 also call for a writing. This writing must have a "date certain" (C.civ., art. 1061) as well as a reference to the secured obligation and a "detailed description" (designación detallada) of the collateral (C.civ., art. 1062).

³⁰ C.civ., art. 890. Moreover, in Peru art. 1077 of the Civil Code appears to contradict art. 1057 of the same code for it provides that the pledgee may appropriate the fruits unless otherwise agreed in the security agreement.

³¹ C.civ., art. 894.

³² Also, even when Peruvian security interests may continue in fruits and products, it is not possible for the secured creditor to appropriate the fruits and products unless so provided in the security agreement, a requirement not needed by modern secured transactions statutes (C.civ., arts. 892 and 895). Consistently, art. 1057 of the C.civ., dealing with pledge, provides that the fruits and "aumentos" (which seem to include any increase in value resulting from improvements) of the collateral accrue to the pledgor, unless otherwise provided.

³³ Attempts to solve these problems under Peruvian law have not been successful: The law may prohibit the sale of pledge collateral, but that would make it impossible to secure loans with rotating inventories. The law may give to the creditor the right to recover the original collateral from whoever has it; however, if the creditor cannot find the original collateral, he may not seize and sell other property that the debtor got.

D. Limits to Using Accounts Receivable as Collateral for Loans

114. *Accounts receivable* can include *any* rights to receive payment. For example, small lenders and NGOs have accounts receivable in their portfolio of many small loans; dealers stores have them in their installment and credit sales. When the law permits using accounts receivable as collateral, it allows formal sector lenders to reach small farmers and the poor. For example, businesses may borrow from banks, using their accounts receivable of installment sales as collateral; with those funds they can expand credit sales to small farmers; or, NGOs may borrow from financing companies, using their loan portfolio as collateral, and refinance and expand their loans to poor borrowers.

115. Such a modern system of accounts receivable financing requires lower transaction cost in: (i) assigning the receivables, (ii) physically transferring the related documentation, and (iii) making public that a lender has encumbered the receivables with a security interest by registration in a public registry.

116. Peruvian law does not provide for such a viable system:

117. Peruvian law provides for a pledge in accounts receivables when the account receivable is a negotiable instrument.³⁴ This is a costly and a limited system: because it requires that the borrower endorse and give possession of each instrument to the lender. Thus, once the borrower has given negotiable instruments as collateral, he can no longer rotate the instruments. If they are instruments at 30 days, that is all the financing that a borrower could obtain with those instruments. For rotating such negotiable instruments parties would need to create a special purpose corporation. The high costs involved in that arrangement become prohibitive costly for small lenders. Moreover, under this system, a borrower may obtain financing from only one lender since only one lender at a time may take possession of the negotiable instruments.

118. Peruvian law also provides for using accounts receivables as collateral by assigning the rights to receive payment.³⁵ However, it involves high costs because it is necessary to notify each

³⁴ The provisions on pledge contemplate the pledge of "rights and negotiable instruments", making it expressly clear that only rights "embodied in a writing" ("que consten en documento") may be given in pledge (C.civ., art. 1084), which appear to rank, in equivocal terms, according to the time in which the credit or right was pledged (C.Civ. art. 1085: "Si sobre un crédito existen varios derechos de prenda, tendrá prelación aquel cuyo derecho preceda a los demás").

If the rights or "credits" to be given in pledge are embodied in negotiable instruments ("títulos valores"), in that case delivery of the document is essential, coupled with any other requirement established by law for transfer of negotiable instruments (C.civ, art. 1087)

³⁵ The Commercial Code [C.comm.] provides in turn for the "transfer of non-endorsable credits", that is, for the transfer of a right to payment arising from a commercial transactions (hence called

account debtor by a notarial letter ("carta notarial").

119. Under this accounts receivable framework NGOs and private non-banks lenders and businesses that sell on credit face a disadvantage. Such entities usually prefer to retain apparent control of their accounts to preserve a direct relationship with their clients; but public assignment of the account is inconsistent with this practice. Some businesses have many small accounts; such credit helps providing access to credit for small businesses and the poor in a socially efficient way. Such accounts receivable, taken individually, are too small to interest a bank or a finance company. However, taken together, they can serve as collateral for a loan sufficiently large to interest a private sector lender. If the law requires that the account creditor transfer each account and that the new lender notify each account debtor of the transfer, the cost of collateralizing these documents, account by account, becomes prohibitive.³⁶

120. Most important, Peruvian law requires registering the assignment or the pledge of accounts receivable in a public registry. This a poor legal provision. However, it is unclear whether the registry works well. Many businesses were unable to get to registered information. In addition, even if the registry worked well, the system would be too risky: the law appears to give priority to collect against the accounts according to the time in which the credit or right was pledged³⁷, and not from the time of registration. Consequently, potential creditors can never learn from the registry if another creditor has a better claim in those accounts.

121. Finally, a limited access to information in public registries has slowed the development of credit bureaus. This makes it difficult and costly for formal sector lenders to learn the default rate of portfolios of accounts receivable.

Options for Solution

122. Expanding access to credit will require law revisions in the secured transaction's framework that:

- Repeal restrictions and instead clearly permit any party to secure all types of obligations against any type of collateral and for any purpose.
- Apply the same priority rules to all transactions, whatever their form, entered into for

"mercantile credits" under art.342 of the Commercial Code) . Although this provision does not require the consent of the account- debtor for the transfer to take place, it is necessary to notify the debtor by a notarial letter ("carta notarial") -

³⁶ See de la Peña, Nuria, Girton, Lance and Fleisig, Heywood, "UNCITRAL: Draft Uniform Rules on Receivables Financing Comments" [September 1995: The World Bank, processed].

³⁷ C.civ., art. 1085.

purposes of security, including financial leases, trust receipts and conditional sales.

- Allow all tangible and intangible property to serve as collateral in possessory and non-possessory security interests, including fixtures, deposit accounts, chattel paper, and patent and trademark rights.
- Allow and simplify floating *security interests* by permitting a *security agreement* to "generally describe" the collateral.³⁸
- Allow security interests to continue automatically in the *proceeds* of collateral, where the law defines proceeds as anything received from the sale, exchange, collection, or other disposition of collateral, and the proceeds of proceeds.
- Provide for a non-possessory *security interest* in accounts receivable. Allow the inexpensive transfer of the accounts by not requiring endorsement or notification of the account debtor to rank a creditor's priority. Instead, set the rank of priority to the first to register a *security interest* or transfer of accounts receivables in a public registry. Make registration a condition to have priority in collecting against the accounts.

123. These revisions will expand access to credit by broadening the property that may secure a loan. These revisions would require legislative enactment. Chapter VII discusses several options for introducing these and other changes into Peruvian law.

In the Short Term:

124. The following options could be undertaken before or in parallel with a comprehensive reform.

- Review banking regulations and decrees to determine the possibilities for relaxing some of these restrictions.

125. Peruvian banking regulations and decrees may include unwarranted limitations on creating security interests. For example, the limitations to leasing and trust transactions seem to serve no important function concerning safety and soundness of the banking system. In the short term, a separate study could cite each change required and draft the needed regulations. These changes would not require legislative action.

³⁸

Under such a system, registries must include a name index.

- Draft banking regulations to improve performance of secured loans under the present legal framework -- study.

126. Changes possible under the current framework could lower the collection risk of some security devices. For example, with alternate registry systems, and the trust, bailment, lease, sale, and special purpose corporations' agreements. For this, a study is needed to suggest changes in specific banking regulations and propose model contracts. If these changes satisfy of the Superintendency of Banks, it can rule that using such model contracts and complying with the requirements set by the new rules permit banks to treat such loans as well secured loans. That would make provisioning requirements more attractive.

127. Such new banking regulations, will expand access to credit in Peru. The scope of the work may include credit for: Accounts receivable, pawnbroking, warehouse receipt financing, financial leasing, and trusts for movable property and real estate loans.

VII. Problems in Perfecting Security Interests

128. Perfecting security interests permits lenders and creditors or sellers to determine the rank of their claims against collateral. This knowledge is crucial in reducing the risk in securing a loan because each lender needs to know whether for example, the borrower might have agreed to pay another loan first from the proceeds of the sale of the collateral. The priority of a lender is essential information in determining that risk. A \$100,000 house might appear an adequate collateral for a \$50,000 loan. But if the house already had a mortgage of \$80,000 against it, which would have to be paid before the \$50,000 loan, only \$20,000 in equity would cover the \$50,000 loan and the house would not contribute adequate collateral.

129. Broadly, two systems exist for ranking claims against collateral: possession and public registration. By taking possession, the debtor gives the collateral to the creditor until he has paid the loan. This system underlines pawnbroking and warehouse receipts financing. However, the debtor cannot use the collateral while the loan is pending.³⁹ In a system using public registration, the debtor keeps the collateral and the parties register the security interests in a public registry. The law then gives priority to the first to register. Most loans in industrial countries are secured this way.

130. Ranking claims against collateral by public registration better expands access to credit to potential borrowers who need to use the property given as collateral. Public registration also allows borrowers to use the same collateral to secure loans with more than one lender. On a system requiring possession as collateral, only one lender at a time may use the goods as collateral. Therefore the borrower can finance these goods with only one lender.

131. In Peru, however, several problems in registering and in retrieving information making it difficult to claims against collateral using public registration. This chapter discusses these problems and their economic consequences.⁴⁰

³⁹ Of course, parties could arrange a simulated possessory arrangement, but we refer here to "true" possessory secured transactions.

⁴⁰ The paper does not discuss problems in perfecting by possession, as few problems were found in such laws. However, the efforts for reform in the short term could focus on the possessory perfection system and related simulated transactions. Particularly in order to improve the risk of collection.

A. Problems in Registering Security Interests

132. Many independent public registries exist, in Peru, which make it costly to register security interests. There are, altogether about twelve registries important for filing security interest against different types of property. Peruvian registries include the real estate registry (Registro de la Propiedad Inmueble) and the registry of movable property (Registro de Bienes Muebles).⁴¹ The registry of movable property will include several other registries.⁴² However, the movable property registry is not yet operating. Each registry that it includes operates independently. These separate registries do not link their information in any way. Therefore, parties must incur in high costs because they would need to check several registries to be sure of all claims against collateral.

133. The registration laws also cause registration problems. Peruvians have enacted many different laws over time that are contradictory, generating serious conflicts on where to register.⁴³ Registering in the wrong registry would be a fatal defect; it would not give the creditor the right to collect against the collateral.

134. Peruvian law also limits the use of public registration to some security interests of some parties. For example, the industrial registry (Registro Industrial) allows only parties dedicated to industrial activity to create non-possessory security interests⁴⁴; other potential creditors have no access to the information in that registry. Similarly, the organic law of the public bank for industry (Banco Industrial) establishes a public registration system applicable only to that bank.⁴⁵

135. Moreover, registering is costly because the registration laws set out a complicated registration process. For example, the law requires that a notary certify many security agreements before they can be admitted for registration.⁴⁶ Notarial fees for this service usually run as a

⁴¹ Both administrated by the office of public registries.

⁴² The movable property registry includes: the stock registry (Registro de Prenda de Acciones,) the registry of agricultural pledges (Registro de Prendas Agrarias), registry of transportation pledges (Registro de Prendas de Transporte), registry of industrial pledges (Registro de Prendas Industriales), the public registry of mining (Registro Público de Minería), the registry of pledges of warehouse receipts (Registro de Prendas de Artículos Depositados en Almacenes Generales), the registry of installment sales (Registro Fiscal de Ventas a Plazos), the registry of ships (Registro de Naves), the registry of aircraft (Registro de Aeronaves), the rural real estate registry (Registro Predial) and the motor vehicles registry (Registro de Vehículos).

⁴³ Peruvian Civil Code of 1984 devotes a book to public registration (Book IX on "Registros Públicos", C.civ., arts. 2008-2045).

⁴⁴ "Prenda industrial."

⁴⁵ Legislative Decree No. 202 (Ley Orgánica del Banco Industrial del Perú).

⁴⁶ See C.civ., art. 2010 (instrumento público).

percentage of the amount secured, making the requirement very costly. Notarial fees of even an ostensibly low percentage amount must be evaluated against the underlying economic transaction. For security interests in inventory or accounts receivable, that may be refiled monthly, even a 1 percent notarial fee represents a cost of more than 12 percent at an annual rate. In Peru, this would represent nearly a doubling of the carrying cost of inventory.

136. Finally, problems exist in the operation of the registries. Registries have a substantial backlog of unprocessed filings. Some interviewees complained about waits of more than 60 days for registration. Some of these administrative delays arise from inadequate registration laws. For example, under Peruvian law, recording officials have authority to review the validity of documents before registering⁴⁷. Such reviews slow registration. The review also "filters-out" filings and many interviewees complained that the denials of registration of documents are often unfounded.⁴⁸

B. Problems in Retrieving Registered Information

137. The registries also displays several problems in retrieving information. Retrieving registered information is crucial for learning about other claims against collateral.

138. **Lack of Public Access.** The main difficulty in retrieving information lies on the lack of public access. Peruvians do not have a registry system that is open to the public and is inexpensive to search. A person can only search any record in a registry with official permission, often difficult to obtain. Furthermore, the laws have organized the registries in ways that make a search technically difficult. Peruvian registries allow a party to obtain information that may only relate to a specific transaction. The public may not directly search records for any registered information. This makes it hard to learn the priority of security interests and, by that, raises the riskiness of lending.

139. Moreover, in Peru, this denial of public access has prevented private companies from getting access to registered information and selling it as a service to the public. Registration systems that allow full public access are crucial in allowing the development those services, especially when the registries operate manually and are difficult and costly to search.

⁴⁷ C.civ., art. 2011.

⁴⁸ The scope of this review includes the legal capacity of the issuer of the instrument and "the validity of the act." The review applies to what appears in the documents, previous documents and entries of the public registers ("por lo que resulta de ellos, de sus antecedentes y de los asientos en los registros públicos").

140. **Credit Bureaus.** This lack of public access to registries in Peru has also slowed the development of private credit bureaus. Such bureaus provide credit information gathered from private parties. Such reports include information on whether creditors have initiated collection actions against a debtor, and whether liens encumber the assets of debtors. However, in Peru, the reports of credit bureaus' lack this information -- it is only available from registries that they cannot access. These problems limit access to credit, because the operation of credit bureaus are crucial for safe accounts receivable financing. Credit bureaus permit learning the rate of performance of the accounts receivables that serve as collateral.

141. Nor is Peruvian law satisfactory from the debtors' side. It does not address many concerns that may arise from an expanded access to information, such as, the functions of credit bureaus, debtors' rights to privacy, issues regarding the accuracy of the information and claims, or time limits for keeping information on file.

Options for Solution

- Enforce a standard of perfection that grants priority to the first claim to register in the public registry. Restrict exceptions only for easily determined cases.

142. The first step in providing for a public registration system involves enacting priority rules that grant a rank of priority to the first to register. Then, and only then, is it worth it to invest in modernizing the functioning of the registries. A chapter of a new secured transactions law may include such priority rules.

- Establish a public registration system that permit lenders to publicly set the existence of their security interests in an inexpensive and rapid way -- Undertake an economic and a technical evaluation.

143. Establishing a public registration system for security interests in movable property would require an economic and a technical evaluation of the many options. Should public or private parties operate the registries? Should many registries exist and compete? How should registries structure registration fees? What technical configuration do they need? What is the least information to register that would balance privacy rights, economic usefulness, and public access? Separate studies must address these issues.

144. The superintendency of registries has yet to establish the operation of the registry of movable property. This presents a unique opportunity for establishing a public registration system for security interests in movable property. Thus, it may prove useful to coordinate with such efforts.

In the Short Term:

- Provide the public with direct access to the registered information -- draft a decree on Public Access.

145. In the short term, public access to registered information will allow private businesses to copy and provide registered information. This would allow lenders to learn their rank of priority in collateral. Also, it would place the management of the registries under public scrutiny. A decree may provide for public access. A short-term study could set out such draft rules for the consideration of the President.

- Introduce legislation for the operation of credit bureaus -- studies for terms of reference and draft rules.

146. It is not clear whether the Peruvian government may introduce legislation on credit bureaus by decree and further research would be required to answer that question. However, a framework for the operation of credit bureaus could be instituted separate from other reforms.

147. Corresponding banking regulation must accompany a credit bureau's legislation. Those banking regulations must require that banks that take accounts as collateral obtain credit reports of account debtors. Also banking regulations must set the rate of performance in the accounts and classify provisioning for losses.

148. A study may write terms of reference for the needed provisions and discuss the proposed framework with interested parties. Once there is an agreement between the interested groups and the government, a separate study may write the appropriate draft rules. This work could start independent of a general legal reform.

VIII. Problems in Enforcing Security Interests

149. In well functioning systems of secured transactions, lenders or creditor-sellers can seize and sell the collateral rapidly. This is crucial in the case of personal property: many types of inventory perish rapidly, either through spoilage or passing out of fashion; accounts receivable have a life of only 30 days; machinery typically depreciates more rapidly than real estate.

150. Peruvian law does not allow the lender to seize and sell the collateral quickly and inexpensively⁴⁹. The delay and costs arise from the slow procedures set by the law, which require substantial intervention by the courts.⁵⁰ Since, much movable property will depreciate before creditors can seize and sell it, creditors regard that property as unacceptable collateral.

151. Three laws govern the sale and seizure of collateral in Peru: the Civil Code, the Commercial Code, and the Code of Civil Procedure.

152. The Peruvian Civil Code precludes methods of rapid seizure, such as strict foreclosure and self-help repossession.⁵¹ It does allow the private sale of the collateral by the secured creditor, "pursuant to the terms of the agreement." However, private parties must still seek a "judicial notification" at least eight days in advance.⁵² The debtor may then raise defenses supported by documents. Those defenses must follow a proceeding applicable to matters of "minor amounts" ("menor cuantía"), which may delay the procedure several months.

153. The Commercial Code is somewhat more liked than the Civil Code; it provides that the secured creditor may sell the collateral pursuant to the terms agreed upon between the parties.⁵³

⁴⁹ In limited cases Peruvian law provides for more expeditious procedures to collect that do not require going to the courts. However, these apply mostly to possessory pledges of a commercial nature, and do not apply to other security interests, Commercial Code [C.comm.], arts. 317-319.

⁵⁰ Peruvian law contemplates several provisions on enforcement of security interests in personal property, scattered through the Civil Code (art. 1069), the Commercial Code (arts. 317-319), and the new Code of Civil Procedure (Decreto Legislativo No. 768, published in "El Peruano" on March 4, 1992 [CPC], arts. 720-748). To this must be added the enforcement provisions of specific types of non possessory security interests, embodied in each of the statutes.

⁵¹ "Aunque no se pague la deuda, el acreedor no puede apropiarse del bien prendado por la cantidad prestada. Es nulo el pacto en contrario." (C.civ., art. 1066).

⁵² C.civ., art. 1069.

⁵³ Article 317 of the Commercial Code provides: ". . .el acreedor podrá proceder a la venta de la prenda en la forma estipulada en el contrato respectivo, que se celebrará por escrito." Only in default of an agreement, art. 318 of the C.comm. requires judicial authorization to dispose of the collateral. It is not clear whether the prohibition against the "strict foreclosure" (pacto comisorio) of the Civil Code [C.civ., article 1066] is applicable to the commercial pledge.

However, the commercial pledge is only one type of security agreement with a limited application and even it requires that the creditor first get a court order to seize the collateral. A creditor in possession of collateral that may be traded in the stock market may sell it through a commercial broker. However, even then, he would also need to seek judicial authorization. With other types of collateral, the sale must take place by auction and with judicial authorization.⁵⁴

154. Finally, the Code of Civil Procedure, which applies to all security interests, sets out a lengthy enforcement process.⁵⁵ The procedure requires a court to seize and sell the collateral. Although, the rules may seem expeditious, in practice the court steps demand considerable time. Moreover, the process for the sale of the collateral is expensive. These costs arise because the Code's judicial sale generates other debts against the collateral that must be paid first. They may include, for example, the attorney fees.⁵⁶ Those claims, alone, can substantially diminish what could otherwise be obtained from the sale of many types of movable property.⁵⁷

Options for Solution

155. Several broad remedies exist to enforce security interests:

- Introduce more expeditious procedures to seize collateral.

156. Peruvians may accelerate seizure of collateral by introducing procedures that do not require judicial intervention. Procedures for considerations could include harmless repossession, administrative repossession, and receivership. They may also accelerate collection by providing summary procedures for court-ordered seizures. A chapter of a new law on secured transactions could set out these procedures.

⁵⁴ C.comm, art. 318.

⁵⁵ The code of civil procedure regulates in detail the steps to be followed in foreclosing any security interest ("garantía real"), movable or immovable, commercial or non-commercial (CPC, arts. 720-748).

⁵⁶ A court appearance requires representation by counsel.

⁵⁷ Under Peruvian law, the creditor must first pay other claims out of the proceeds of the sale of the collateral before the secured creditor receives any amounts due on the debt. These claims can include court costs, expenses for the maintenance of the collateral, rents due on the premises where the goods were, appraisal fees, auctioneer fees, attorney fees for both sides, and accrued property taxes related to the collateral. For a creditor who contemplates making a loan, any unknown potential claim will increase the risk of collection on the loan and lowers the values of the goods as collateral.

- Allow creditors to control the sale of the collateral.

157. Peruvian laws on the sale of collateral do not permit a quick or cheap enough sale to permit most types of personal property to serve as collateral for loans. To address this, a new legal framework for secured transactions could include a unique set of rules for a creditor-controlled sale of collateral. These rules should apply uniformly to all creditors, and judicial intervention during the process should be minimal. If judicial issues arise, the law will maximize the value of personal property as collateral if it postpones their resolution until after the collateral has been sold and the creditor has been paid. The main revisions to provisions on private sale should ensure that:

- The debtor receives the maximum sale price from the sale of the collateral.
- The debtor receives any surplus remaining after the creditor has been paid.
- The law maximizes scope for private action and minimizes court intervention.
- The procedure has broad application to all secured transactions.

158. A creditor-administered sale lowers the costs of collection to the creditor. This is because the creditor is paid first, without his claim being offset by other claims on the collateral that usually arise in a court-administered sale. For example, court costs, fees for an appraiser or expert, and commissions to the court-appointed auctioneer. Moreover, the sale can occur when the creditor desires, without any expensive delays.

159. To protect debtors against unfair disposition of the collateral, the law should hold creditors to a standard of "commercial reasonableness." This requires a creditor to sell goods as would a dealer in that type of good. Any delay in the disposition of perishable collateral, or any delay likely to reduce the value of the collateral, may be a failure to act in a commercially reasonable manner that would make the creditor liable. Also, the law would prevent the secured creditor to collect any deficiency (No difference between the outstanding debt and the proceeds of the sale) if he had not complied with the legal requirements.

160. The law would also require creditors to notify debtors and junior secured creditors before any resale of the collateral. The law must always give the debtor a redemption period during which he can reclaim the collateral by paying the debt. The law should void any stipulation that allows the debtor to waive his right to redeem the collateral before foreclosure. The debtor should also be allowed to recover any damages arising from a wrongful seizure, including cases where the debtor did not default or where the creditor had no *security interest* in the seized property.

161. Once the secured creditor recovers the collateral, the creditor should be allowed to retain it in complete satisfaction of the secured debt (*strict foreclosure*). The law should provide that the parties may not agree to strict foreclosure before the debtor receives notice of default. Or, the

law may prohibit strict foreclosure against a consumer who has paid a fixed percentage of the debt, since strict foreclosure should not allow a creditor to recover any deficiency, nor a debtor any surplus.

- Enforce the rank of priority of security interests.

162. The new secured transactions law must clearly establish the priority of secured creditors by listing on a case-by-case basis the different priority rules governing all possible conflicts. These priority rules should apply to all secured transactions despite their form.

In the Short Term:

163. It was not possible to identify any reform that could speed up enforcement of security interests in the short term. Most problems arise from the laws; the enactment of regulations by decree could not modify these laws.

164. However, banking regulations could endorse model contracts that speed up collection. Under the current framework model contracts may (i) give to creditors control of the collateral and (ii) allow parties to agree to a private sale. These provisions in the contracts avoid the costs and delays of the court procedures. For example, the contract may include the trust, bailment, sale, lease agreements and special purpose corporations. Section VI above has discussed this option.

IX. Options for Reforming the Framework for Secured Transactions in Peru

165. This paper has discussed many problems in Peru's current pledge law and other related secured transaction's laws. It has explained how changes in those laws would ease access to credit and lead to lower interest rates on loans secured by movable property. The laws needing reform include substantive laws that set out the rights of creditors and debtors and procedural laws that set out how to enforce these rights.

166. Peru has a broad range of options for reform: at one extreme, it could entertain piecemeal revision of each element of the law that creates economic problems. At the other extreme, it could consider a comprehensive reform. Such a reform would include the creation, perfection, and enforcement of any security interest, including the pledge and any other security devices.

167. What is the most effective and efficient way to introduce such a comprehensive secured transactions framework in Peru? The "correct" solution will balance, in the view of the Peruvian farm, business, and legal community, the economic gains to the concerned groups with the legal and procedural difficulties that each option involves. Final determination, therefore, should await consideration of these issues in an open forum where the interested groups can discuss the issues and consider the costs and benefits. This chapter sets out several strategies for consideration.

Options for Solution

Option One: Enact piecemeal reforms

168. A piecemeal reform effort would require separate and specific laws to address each problem raised in the discussions of creation, perfection and enforcement. Historically, this is the path originally followed by the United States and Canada. As economic need required it, they passed new and different lending laws to fit each transaction. Such a solution has some appeal: the required legal change appears at first to be simple and involving no substantial change in the underlying system.

169. However, these appearances may deceive: the support for a unified general security interest in the United States and Canada grew out of the problems created by a proliferation of special laws. Multiplicity of laws sharply increases the possibility of inconsistency. For lenders, this growing inconsistency raises the prospect of conflicting priorities and enforcement systems that raise the risk to the loan. More possible inconsistencies means more risk in making loans. However, raising risk defeats the purpose of the reform. The reform aims to reduce risk and, by that, increase the flow of credit and reduce interest rates. This is the present situation in Mexico. Mexico may appear to have a richer framework for secured transactions than does Peru. In fact, lenders there deliver little credit secured by movable property because of the bewildering complexity and lack of certainty that this fragmented legal framework produces.

170. As a drafting and logical issue, a general security interest law, such as that existing in North America, resembles an instruction to "include all the numbers between zero and one." The piecemeal solution resembles an instruction to "name all the numbers between zero and one." This may seem like a small point, but the difference in principle is large: As a logical matter, it is not possible to "name all the numbers between zero and one." Indeed, whatever two numbers are named between zero and one, it will always be possible to name another number between those two numbers. It is in this sense that the specific piecemeal approach to reform will always miss some important economic transactions. Also, it will lack the completeness made possible by the general security interest. Because of this, the apparent simplicity of the piecemeal reform will, quickly, lead to much greater complexity. In view of this, Peru may choose to pass over this stage of development and move directly to the more general view of the security interest.

Option Two: Enact a special law [*Ley Especial*] on secured transactions that introduces a unified security interest. Apply that special law to all transactions and goods and replace existing security interests, like the pledge.

171. Under this option, the special law on secured transactions would introduce a unique and unified type of security interest. The rules for security interests would apply to all transactions and goods and that replaces existing security interests, like the pledge. Several scholars have advocated this approach. They recommended that Germany and member countries of the EEC adopt Article 9 of the U.S. Uniform Commercial Code, after technical adaptation of the main features of the article.⁵⁸ This approach introduces a new word for naming the new *security interest*: "charge" or "*security interest*" (*garantía real*). Then, the law defines the new *security interest* as a general, uniform idea that embraces all types of *security interests*. This option has the advantage of avoiding confusions between the old rules and the new ones.

Option Three: Introduce a special law [*Ley Especial*] for a new type of security interest without changing the current laws.

172. Another option is to leave other existing security devices and introduce a new comprehensive *security interest*. However, this special law must make its rules regarding perfection and priority applicable to the other existing security devices. Otherwise, a conflict will result regarding the priority position of the different creditors. The apparent "gradualism" of this approach, however, is deceptive: The need for consistency would require overruling so many provisions in the existing security interest laws, like the pledge, that the option becomes very similar to the one above.

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In Germany and other member countries of the European Economic Community it is possible to adopt a statute modeled to Article 9 of the U.C.C. because the pattern of secured financing in the receiving countries is similar to that underlying the code. However, the diversities in drafting techniques, in concepts, in the general structure of the legal systems are too great to permit a reception *tel quel*. See Ulrich Drobniig, "Is Article 9 of the Uniform Commercial Code Exportable? A German View," *Aspects of Comparative Commercial Law: Sales, Consumer Credit, and Secured Transactions*, McGill University, Montreal, Oceana Publications Inc., Dobbs Ferry, N.Y. (1969).

Option Four: Introduce a special non-possessory pledge law that replaces the existing ones.

173. Under this option, Peru would amend the pledge law to create a unified *security interest*, as in the first option. However, it would call it a pledge instead of a *security interest*. The law must (i) give to this pledge the qualities described in this report (floating, continuation in proceeds, after-acquired property, etc.); and (ii) make priority, perfection, and enforcement rules applicable to any other security devices (like financial leasing and conditional sales).

174. This option has the desirable feature that it continues the use of the term (*prenda*) with which the Peruvians are familiar. To a degree, this was the strategy followed in Quebec. It reconciled its civil code provisions with the common law provisions in the rest of Canada by greatly expanding and redesigning the traditional *hypothec*. However, this approach has the disadvantage that some may be confused when the traditionally known characteristics of the pledge would no longer be valid. Also, Peruvians may confuse the application of the new pledge rules with old ideas, thus diminishing and frustrating the public policy followed in the new law. However, the law could reduce this risk by making clear descriptions and distinctions of ideas and by not leaving gaps that would require using old ideas.

175. Beyond these main options, some general points merit consideration by Peruvian policymakers and by the farm and business community:

- **Undertake the reform in one stage, by drafting a special statute on secured transactions. In that same statute, assign to a private group the task of continuing revision and adaptation.**

176. If Peruvians adopted the options for legal changes set out in this report, it would be useful if they set out the changes in a separate statute, not one that corresponds to a chapter in the Commercial or the Civil Codes. Such a special law would allow further revisions and amendments without requiring a major restructuring of the codes. This approach already proved successful when Peruvians enacted the pledge law.

177. Also, the establishment of a new secured transactions framework would be easier if undertaken in one continuous stage. Multi-staged drafting would not work well for improving access to credit because many recommended legal features do not work without the others. As such, the proposed changes have interrelations that must be preserved. For example, introducing in a first stage a security interest that applies to all movable goods, but that leaves intangibles for a second stage, would not improve lending for equipment. Even though a dealer might finance sales of equipment, the dealer would be unable to refinance that sale with the chattel paper that his sales generate. Consequently, the dealer would be unable to get credit for his sales and would not sell more equipment on credit. Rather, the dealer would be limited to what he can already sell

with bank financing based on his real estate -- the problem that we are trying to avoid.

178. For future change in the statute done in a single stage, the statute must assign to an interested private group the duty of continuing revision and adaptation. Then, many specific issues of priority could be ironed out in subsequent stages.

- **Train lawyers and judges on the new framework and on its importance in expanding access to credit**

179. The commercial groups and registries, as major interested parties in the reform, should lead the instruction in the new techniques of legal counselors. The bench and bar at large, and any of those who will use and apply the legal tools placed at their disposal. It is necessary to train lawyers and judges on the new ideas, like *cuentas por cobrar*, rights in the collateral, or continuation in proceeds of collateral, so that they apply them correctly and enforce the law in a way consistent with the underlying public policy issues.

- **Help consumers and small commercial users -- simple drafting**

180. The drafting policy might emphasize simplification, providing a readily usable statutory framework, and using terse legal Spanish and civilian terminology. This would lower the cost of using it by the farm and business community. Suggestions of forms and model contracts, perhaps incorporated into the law, would ease its understanding and use by non-lawyers. For most businesses, a simple statute will reduce the costs of securing lending with movable goods.

- **Registry Reform follows Legal Reform**

181. Several reforms of registry regulation would allow the Peruvian registry system to serve better the public interest. The vast expansion of business that will take place after the enactment of the law will require an expansion of registry features and a modernization of the way they operate. However, the new law will define how the registries operate: Attempts to modernize the registries, therefore, without considering the appropriate legal reform are unlikely to result in wise investment in registry equipment. The precise method of data retrieval and, consequently, the type of hardware and indexing software requires prior definition under the law.

182. However, in each case, it was unlikely that a market could develop when the security agreements that underlie the securities cannot be enforced. Particularly lacking are security interests that are simple to set up and cheap and quick to enforce. Especially without floating security interests and security interests that could continue in the proceeds of collateral or without faster enforcement procedures, the collateral that back up the securities would be very difficult to cash in the case of non-payment. That alone would make such instruments very risky. The underlying problem is the lack of the necessary features for security interests and that problem would not be attended by instruments that build on that problem.

183. In each case, the businesses interviewed recognized this problem and supported a plan to improve the movable property security interests laws. Also, for the short term, they discussed ways of improving enforcement for certain security interests without changing the law.