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Bringing More Dead Capital to Life

Issue 8

Movable property registries provide much needed support for economic growth and development. By expanding the types of property that can be used as collateral beyond just real estate, they offer the possibility of finance to a much wider section of the population, including small producers and other rural residents who are often excluded from the secured lending market.

MOVABLE PROPERTY AND ACCESS TO RURAL AND AGRICULTURAL CREDIT

It is well known that banks are more likely to lend—and at better rates—when a borrower can offer collateral to secure the loan. Lenders may provide unsecured credit to some borrowers, but the amounts are less and the costs are higher than for secured loans.[1] This can be particularly true outside the urban centers, where seasonal production cycles and cyclical cash flow require flexibility in structuring credit. When borrowers can offer valuable collateral, lenders provide more and better rural and agricultural credit.

Worldwide, the best known and most utilized form of collateral is real property—land and the buildings on it. Unfortunately, many people in developing countries do not own real property, or not in a manner that banks recognize as acceptable collateral. Farmers often own land, but even if they have titles, they may be understandably hesitant to risk their newly titled holdings to secure loans. Others may only rent or hold customary rights, which are generally not accepted as collateral. More options are needed to expand access to secured lending in the agricultural sector.

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[1] Fleisig, Haywood and Nuria de la Peña, "Microenterprises and Collateral," Center for Economic Analysis of Law (CEAL) Issues Brief, No. 2, Washington, D.C., September 2002. http://www.ceal.org/ceal-org/publications/IB_02.pdf

Movable and intangible property can serve as collateral and broaden the secured lending options for both borrowers and lenders.[2] Tangible movable property such as cars, tractors, farming equipment, inventory, crops, cows and a host of other items are valuable forms of collateral in some countries. Intangible property—accounts receivable, trademarks, leases, future harvests and even rights in these rights (derivatives)—can also serve as collateral and enable producers to meet financing needs. These various forms of property can be used effectively for secured lending, however, only if the legal system permits their use as collateral.

Developed economies generally permit the use of immovable, movable and intangible property as collateral. In much of developing world, movable and intangible property are overlooked. For example, Nigeria recognizes only 10% of the types of assets used in the United States as acceptable security for a loan.[3] In Canada, livestock are frequently pledged to secure loans, but this is not legally permissible in Latin America. To reach the poor in developing countries more effectively, it is time to expand the range of collateral available to them. This note explores the rationale for moveable property registries and how these systems work to broaden access to credit.

THE MYSTERY OF COLLATERAL EXPLAINED

To survive, succeed, and grow, a bank or business must balance its costs, risks and revenues. A lender operates by generating revenues through fees and interest, but will only succeed if those revenues cover all costs and risks of lending and provide a reasonable return on the investment. If costs or risks go up, then fees and interest rates go up, which means that the bank will have fewer customers that can afford their services, and fewer borrowers will obtain the finances they need. Lenders gain nothing from higher costs or risks; in fact, they are hurt by an expensive lending environment which, by its nature, is more susceptible to business failure.

Costly credit is hard on businesses. A business—whether urban or rural, agricultural or industrial, formal or informal—must cover its costs, including the costs of finance, through the prices charged to customers. If the business's prices are too high, it is unlikely to sell as many goods or services, and is at greater risk of failure, especially if competitors are able to obtain their financing more cheaply and thus reduce their prices. Reducing the cost of credit therefore has a positive impact on businesses, banks, employment and the economy in general.

Collateral lending increases access to credit because it reduces the costs and risks of lending. In a competitive lending environment, this means that the lender's savings can be passed on to the borrower in the form of lower fees and better terms. In Albania, adoption of a modern collateral system in 2001 reduced risk premiums by half and lowered interest rates by 5 percent. In Romania, interest rates have dropped by 20 percent since the new collateral system was introduced in 2000.[4]

Modern collateral laws also expand the population of potential

[2] For convenience, we generally refer to only movable property—as opposed to immovable property, such as land and buildings - but include intangible property in that definition as well. (Intangibles, technically, are movable even if not tangible). Modern movable property systems handle tangible and intangible property.

[3] Safavia, Mehnaz, Heywood Fleisig and Jevgenijs Steinbuks, "Unlocking Dead Capital: How Reforming Collateral Laws Improves Access to Finance." World Bank, Public Policy Journal, Note No. 307, March 2006. http://rru.worldbank.org/PublicPolicyJournal

[4] Safavia 2006.

borrowers and lenders so that there is greater competition to provide credit, and greater demand for secured lending. Not only banks, but wholesalers, manufacturers, leasing companies and even merchants, can use the registry system to provide secured credit directly to customers, possibly at better terms than the local bank. These factors expand the availability of credit while reducing the costs. The reduced costs in turn make secured credit available to a wider number of potential borrowers.

THE OTHER PROPERTY: MOVABLES AND INTANGIBLES

In developed economies, virtually anything that can be sold can be used as collateral for credit. Movable property such as livestock, crops, and farm equipment is widely used. But intangible property – such as receivables or future crops – is also property, and the better credit systems recognize this fact. In order for this wide range of property to be utilized as collateral, however, the law must recognize these possibilities and permit enforcement of the various rights and obligations through a movable property registry system.

Modern pledge systems, unlike traditional possessory pledge systems (such as pawn shops), allow someone to borrow money for purchase of productive assets, then use those assets to generate income while repaying the loan. They can also secure the loan with existing or future existing assets – such as products they make or equipment they own. In fact, commercial loans that use such collateral are self-liquidating: the items being pledged are used to produce the revenues needed to pay the loan. For example, an egg producer can secure a loan for buying feed by pledging revenues from egg sales; the sales proceeds will be both the collateral and the source of loan repayment. Typically the lender will also take a lien on the hens and the henhouse as a secondary source of repayment, and in the event of default, (for instance, sales proceeds diverted to other uses or a failure to sell the eggs) the lender can sell these assets to reduce the outstanding balance. By broadening the range of assets that can be used as collateral in this way, a country can substantially expand the potential for secured lending.

How Does It Work?

Modern collateral lending systems combine a business-oriented legal framework with a public registry to give borrowers and lenders maximum flexibility in structuring lower cost, lower risk transactions. The basics are simple: a borrower pledges valuable assets to the lender to secure a loan.[5] The lender then registers the interest in a public registry and enters a loan agreement with the borrower. The agreement permits the lender to enforce the loan by taking and selling the assets quickly if the borrower defaults.

The law and registry are the foundation of this simple system. An increasing number of nations are beginning to demonstrate how to reform laws and establish registries effectively. Recently, countries ranging from Georgia and Madagascar to Colombia and Tajikistan have begun to analyze and implement the changes needed to expand access to credit in this way.

It is important for new reformers to capture the proven approaches in order to replicate the benefits. These include:

- *A broad range of assets and interests.* Collateral law should place no limits on what can be used as collateral, but allow the lender and borrower to work that out.[6]

[5] Of course, the borrower must also provide a convincing argument that the loan can be repaid. As with land, movable collateral alone is not enough to get a loan.

[6] This does not include illegal substances and other violations of public policy, which should continue to be regulated under other laws.

Moreover, the borrower does not necessarily have to own the physical assets—all that is needed is an enforceable interest in them. In addition, a third party can provide assets on behalf of the borrower.

- *Rapid and affordable enforcement.* The pledge agreement, backed by the law, should permit the borrower to give the lender accelerated, simple enforcement rights, including repossession and private auction.
- *Clear priority and publicity.* By registering a claim, the lender establishes priority over the assets, in case other creditors try to seize those assets for their needs. Also, potential lenders can determine whether there are prior liens and structure their loans accordingly.

Why Does It Work?

Collateral lending against movable and intangible property lowers the costs and risks of lending to both the borrower and the lender.

Lower Risks. When risks are high, banks must charge more to cover them. Collateral systems reduce the risks of lending in significant ways. The primary risk for lenders is non-payment, either by design (fraud) or default (business failure). For borrowers the risk lies in losing valuable property – property they rely on for their income or well being, such as land, facilities or even homes. If a wider range of assets can be used as collateral, borrowers can avoid putting such property at risk by shifting the risk, in many cases, to the new collateral.

- *Fraud.* Movable property registry systems substantially reduce the risk of fraud for a simple reason: the lender's claims attach to both the assets and any proceeds of the assets. This allows lenders to attach assets even if the borrower has transferred them fraudulently. As a result, buyers make sure that the transaction is clean. Moreover, registration of an interest makes it public, and transparency reduces fraud.
- *Default.* Sometimes borrowers default because the market changes without warning and they cannot adjust. At other times, they contribute to failure through poor financial management. A collateral lending system improves allows lenders to repossess assets, which causes borrowers to prioritize their loan payments.
- *Court.* Law suits are risky. Expedited enforcement under a modern collateral system reduces delays and increases collections.
- *Certainty.* Registered pledges establish clear rights and priority and eliminate conflicts and confusion among creditors.
- *Resale Value.* Pledged assets normally have readily identifiable market value for resale, otherwise they are not accepted as collateral. This improves likelihood of recovery in the event of repossession.
- *Proportionality.* For borrowers, the greatest risk is losing property. With movable property, the loss is proportionate—only the pledged collateral is lost, and that collateral can be better matched to the size of the loan.

In Bosnia, USAID helped the government and banking community set-up an internet-based registry that handles more than a thousand registrations per month with only one employee, plus a part-time computer-service contract. With each registration priced at only $10, the registry earns more than $100,000 per year, net of costs, for government accounts. Banks and borrowers are also pleased with this low-cost system.

Lower Costs. Each step of the pledge system can reduce costs, especially on repeat transactions. In a competitive environment, savings to the lender are passed along to borrowers, which enables them to maintain competitive prices through lower costs. This happens in a number of ways.

- *Creditworthiness.* Registered pledges create a credit history for borrowers leading to better terms while simultaneously lowering lender cost of credit analysis.
- *Titling costs.* Movable and intangible properties do not have high, up-front titling or registration costs. No expensive identification or filing is required.
- *Registration.* Collateral registration requires a simple description with basic information about the lender and collateral owner. The form (if required – newer systems are paperless) is normally less than a page. Registration fees, consequently, are very low.
- *Enforcement.* By taking enforcement out of the courts, the process of repossession and sale can save years of time and thousands of dollars in expense. Studies show that quality of enforcement has a direct impact on improved quantity of credit available and better interest rates.

COLLATERAL LENDING IN ACTION: AN EXAMPLE

Imagine a market for tractors priced at $3,000 per unit. Farmers could double their productivity with the tractors, but cannot afford the purchase price. Lenders are willing to provide loans, but only if the borrower can secure the loan with land or guarantees. Most farmers do not have title to their land and have only limited access to guarantees from relatives or patrons who charge high rates.

An equipment supplier in a nearby city recognizes the large potential for these sales of these tractors, but needs financing to purchase them for resale. Unfortunately, the supplier is renting his premises and does not own any real estate to offer as collateral. Unable to obtain financing, he must rely only on self-financing, purchasing only a few tractors at a time and foregoing discounts for bulk purchases. With little credit available to farmers or suppliers, few tractors are sold.

With a movable property registry system in place, this picture can change significantly. First, banks will accept the tractors as collateral, along with a claim on the farmer's future products produced with the equipment. Farmers can purchase the tractors on credit to be repaid through increased production.

Next, the supplier can purchase tractor inventory on credit, using this inventory as collateral. The supplier can also offer financing to the farmers directly, providing tractors on credit and registering a pledge, just as a bank would do. Moreover, as business increases, the tractor supplier may be able to obtain a working capital loan secured by receivables from the equipment business. The supplier's bank, in turn, can use its own portfolio of loans from various suppliers, farmers and other borrowers as collateral to obtain additional lines of credit.

Collateral lending can thus improve access to finance by expanding both the demand for and supply of credit. Yet, while this scenario is quite feasible, such practices are still not the norm in most developing countries.

ESTABLISHING A MOVABLE PROPERTY REGISTRY SYSTEM

Collateral laws and registry systems are not out of reach for developing countries. Today, it is possible to design, implement and install a self-financing pledge registry for approximately $500,000 in 12-24 months. A number of international organizations, including the European Bank for Reconstruction and Development (EBRD) and the Organization of American States (OAS) have established

COLLATERAL: WHO CARES?

Lenders

- Lower risk of default
- Lower risk of fraud
- Lower transaction costs
- Lower collection costs

Borrowers

- Lower interest and fees
- Lower risk of catastrophic loss
- Greater access to affordable credit
- Greater flexibility in financing

Government

- Improved economic growth
- Improved business environment
- Revenues from registry
- Reduced court involvement in transactions

Vendors

- Greater opportunities for credit sales
- Better access to credit

Capital Markets

- Improved foundation for financial markets
- New financial instruments
- New opportunities for investment

principles and model laws that are useful for guiding the legal reforms necessary in any legal system, whether based on common law or civil law traditions. By using internet-based technology—even in countries with poor electricity supply—it is possible to create a registry with only a small staff that can handle all of the country's collateral registration needs. Further, an internet-based system eliminates the access problems associated with a physical registry—these are typically located in large cities, and can be an impediment to rural and agricultural finance because of the difficulties associated with registering property or searching property registers from a distance, including costs of travel to use the registry.

Legal reforms should include review and probable amendment of a number of other laws, primarily bankruptcy, civil procedure, and tax law (particularly with regard to government claims for unpaid taxes). The leasing law should also be harmonized with the collateral law, to permit leasing companies to register their interests in leased property and to use accelerated enforcement proceedings. Leasing is another important tool in the investment financing toolkit, and while it is possible to permit leasing without a movable property registry, leasing systems usually rely on vehicle or other equipment registries maintained by the government. A movable property registry can dramatically expand the range of leasable assets, such as Macedonia, which recently introduced livestock leasing.

A SILVER BULLET?

There are no silver bullets. Movable property registries lower the costs and risks of lending, and thereby enhance the supply and terms of credit available in an economy. The extent of the benefits depends on other factors as well—such as macroeconomic stability, successful enforcement, consumer protection against predatory practices, and even the presence of reasonably priced insurance for some forms of collateral.

These systems have been proven to work in a range of developing countries. In the past few years, movable property registry systems have been adopted in Serbia, Albania, Kosovo, Macedonia, and Bosnia, along with other Eastern European states. Systems are being developed in Morocco, Madagascar, Armenia and Kazakhstan. A number of Central American countries are currently exploring a harmonized system for the region.

Movable property registries provide much needed support for economic growth and development. By expanding the types of property that can be used as collateral beyond just real estate, they offer the possibility of finance to a much wider section of the population, including small producers and other rural residents who are often excluded from the secured lending market.

Recommended

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