

PUBLIC POLICY FOR THE

Private sector

The World Bank

April 1995

Note No. 43

The Power of Collateral

How problems in securing transactions limit private credit for movable property

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The first question any private loan officer is taught to ask is, “How do I get my money back?” Borrowers have offered two broad answers to that question: giving an unsecured promise to pay, and offering collateral that can be seized and sold by the lender if the borrower fails to pay. This Note discusses the second type of borrowing. Drawing on several World Bank–supported projects, it sets out how legal and regulatory constraints on using movable property as collateral limit access to credit in many client countries. The problem is potentially severe. In industrial countries, movable property—livestock, machines, inventory, equipment, standing crops—can represent as much as a third of the capital stock and half of investment. Where borrowers cannot use this property as collateral for loans, they must pay higher unsecured interest rates. Consequently, they hold less capital per worker and produce less output per person. In Bolivia, the loss in GDP from an inadequate framework for secured transactions is estimated at between 5 percent and 10 percent.

Collateral and lending

Why does a lender believe a borrower will pay? One way for the borrower to prove sincerity is to offer collateral: to place property at risk of being seized if the borrower fails to pay. The power of collateral to increase the amount that a creditor is willing to offer is apparent in most lending institutions. For example, the Bank-Fund Federal Credit Union offers loans of 6 months' salary with only a signature, 12 months' salary against a car or other movable property, and 4 years' salary against a house or other real estate. In these examples, the borrower, loan officer, loan committee, and lending institution are the same; only the collateral differs. In addition, the power of collateral to reduce risk overrides the increase in the term of the loan—the 6-month unsecured loan will have a higher rate than the 4-year car loan; the car loan will have a higher

interest rate than the 15- or 30-year mortgage interest rate. These practices are not peculiar to the Credit Union. Private lenders in Bolivia, Bulgaria, or Boston behave the same way.

Barriers to using movable property as collateral

Despite the importance of collateral in enabling private lenders to offer larger loans with less risk and therefore at lower interest rates, legal and regulatory barriers make movable property nearly useless as collateral in many Bank client countries. The barriers arise in the following way. When a lender offers a loan against collateral offered by the borrower, the lender is said to take a *security interest* in the collateral. Three legal and regulatory issues are of key economic importance in limiting security interests in movable property:





- The *creation* of security interests
- The *perfection* of security interests
- The *enforcement* of security interests.

These are abstract notions that are easiest to understand with an example. Consider cattle in Uruguay and Kansas. These places have similar topographies, well-educated populations, and advanced agricultural systems that place them among the world's most competitive ag-

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ricultural exporters. In Uruguay, no private bank would accept cattle as collateral for a loan. By contrast, in Kansas, cattle are considered the best collateral for a loan. This is the view not only of private banks, but also of bank examiners. In Kansas, good banks have “cattle paper,” and risky banks have “exposure to real estate.” But in Uruguay, where banks also are closely regulated, the bank examiners prefer that banks take real estate as collateral for secured loans. How can such a difference exist?

Creating security interests

First, it is difficult to create a security interest in cattle in Uruguay. Suppose a bank lends against 100 cattle worth \$200,000. Uruguayan law calls for enumeration of the property—an easy “pledge” against cattle might name the cattle: Bessie, Elmer, . . . —or identify them by tattoo. But this specific identification makes monitoring the loan expensive for the bank because the loan officer must ensure that his bank's specified 100 cattle are in the farmer's field—a different herd of 100 cattle would not secure the loan. The bank might try to get around this by writing a general pledge contract against, say, 100 calves—but in a year the

calves would become cows, and the legal security of the contract would be questionable. By contrast, in the United States or Canada a binding agreement can be written secured by a *floating security interest* in “\$200,000 in cattle.”

Moreover, in Uruguay, the bank would have to worry that the farmer would sell the cattle without notifying the bank. The U.S. or Canadian bank, however, would automatically get a *continuing security interest* in the proceeds of the sale and could automatically attach them—whether they had been put into a bank account or a tractor.

Perfecting security interests

Second, it is difficult to perfect a security interest in Uruguay. To have confidence that collateral has value, the lender must be sure that no prior superior claims to the collateral exist. But how can the lender even be sure that the collateral belongs to the person possessing it? Suppose the cattle had already secured a loan or had been purchased on credit? In Uruguay, it is extremely difficult to search the records for prior claims against collateral. The lender must know the date of a prior agreement and cannot search by the name of the borrower or the description of the pledged asset. It is even more difficult in Bolivia, where the pledges are filed chronologically and the entire registry must be searched to discover a prior pledge. In Bulgaria, no separate registry for such security interests exists, and a search for prior claims would have to extend to each notarial registry in the country. In the United States and Canada, however, registries are public and easily searched, and it is not uncommon for all commercial agents in an area to know the size and sequence of the security interests in a farmer's livestock.

Enforcing security interests

Finally, it is difficult to repossess and sell the pledged collateral in Uruguay. Repossessing and selling collateral requires six months to

two years. Unlike in other systems, private parties cannot contract to repossess and sell collateral without a lengthy legal process. Neither can nonjudicial government officials. Nor are parties permitted to attach other property of the borrower, such as the proceeds of the sale of collateral. In Kansas, by contrast, cattle offered as collateral may be repossessed and sold in as little as one to five days. Loans represent a high percentage of the collateral's market value, so interest rates charged range between the prime rate and the home mortgage rates.

What to do?

First, consider some attempts to deal with the problem that have major shortcomings:

Make the loans anyway. Since no private bank will do this on its own, some kind of loan guarantee system will be required. Alternatively, a state-owned institution could make these loans. However, two problems arise with these options. First, the guarantee fund or the institution that makes these loans is going to have the same trouble collecting the loans as the private bank. Second, because borrowers will know that these loans are hard to collect there is a greater chance the loans will not be put to good use. The result is a money-losing government program without much effect on productivity and therefore a program that is subject to increasing political attack as the credit line goes into default and potential borrowers wait longer and longer for a chance to get ever-dwindling numbers of cheap loans.

Ignore the law. Some lenders simply seize and sell the collateral for a loan despite the absence of any legal sanction for these actions. Some leasing operations disguise the transaction, pretending that a seizure is not a repossession. Some nongovernmental organization lenders take the debtor's property with the passive consent or active participation of the police. In several countries, men with guns are dispatched to repossess and sell large and valuable pieces of machinery sold on credit.

Abuse the law. In some countries, lenders use a postdated check to convert nonpayment into a criminal offense. In Bolivia, for example, a lender will demand a postdated check in the amount of the loan and the interest. On the date that the loan is due, the lender requests payment. If the borrower cannot pay, the lender deposits the check and gets it back from the bank marked "check without funds." The lender brings the marked check to the police, who



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arrest the borrower for writing a check without funds, a criminal act in Bolivia. The borrower spends about a week in the downtown jail, trying to raise the money through friends and relatives. If the borrower fails, conviction is virtually certain. The sentence for writing bad checks now is about four years. But before a legal reform in 1994, the judge also would set a civil penalty equal to the value of the bad check—and borrowers would stay in prison until they paid their debts. In La Paz, half the prison inmates are serving sentences for non-drug offenses; of that half, half are there for postdated checks. All of those interviewed in the course of the World Bank study were businesspeople. Many of them are single women without family connections to raise funds to cover the bad check. And many have their children living in the jail with them.

What's wrong with these solutions? To paraphrase, they are not only wrong, they are inadvisable. Formal sector lenders cannot afford to use illegal collection techniques because the



risk of civil and criminal damages is too great. Consequently, the vast resources of the formal sector are not tapped for credit. Movable property remains the domain of expensive informal sector methods. Why expensive? Expensive to individuals, because the subjective cost to a businessman of going to jail for a business miscalculation will tend to reserve these loans for only the highest-return operations. And expensive to society, because incarcerating risk-taking businesspeople is a dubious development strategy.

Better solutions

In the Bank's operations in Argentina, Bolivia, Bulgaria, and Uruguay, the following possible solutions have emerged for government consideration:

Creation of security interests: change the law to permit the creation of a wide variety of security interests in a wide variety of property.

Perfection of security interests: make public the records of the registries, restructure the public registries, change their incentives by introducing competition among public registries or permitting private registries to compete with public registries.

Enforcement of security interests: change the law to permit private parties to contract for nonjudicial enforcement of debt contracts.

This Note draws on World Bank economic and sector work and lending operations in Argentina, Bolivia, Bulgaria, and Uruguay, undertaken under the broad supervision of Zeljko Bogetic, Mariluz Cortes, Vicente Fretes-Cibils, Jonathan Parker, R. Kyle Peters, Stephen Schonberger, and William Shaw. The work was carried out by a team that included Willem Buiters, Ronald C.C. Cuming, Nuria de la Peña, Ulrich Drobnig, Alejandro Garro, Lance Girton, Boris Kozolchik, Graciela Rodriguez-Ferrand, Stephen Salant, Harry Sigman, and J.A. Spanogle, as well as many lawyers, economists, and financial specialists in the borrowing member countries. The underlying papers are available from the author.

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