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PUBLIC POLICY FOR THE
privatesector

NOTE NUMBER 307
MARCH 2006
THE WORLD BANK GROUP PRIVATE SECTOR DEVELOPMENT VICE PRESIDENCY

Unlocking Dead Capital

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How Reforming Collateral Laws Improves Access to Finance

Collateral can increase access to finance, especially for small firms, and lead to better terms for loan contracts. Many argue that firms are excluded from formal credit markets because they lack assets that can serve as collateral. In fact, firms generally have a wide array of productive assets that could secure a loan—but the legal framework prevents this. Reforming collateral laws can unlock "dead capital," as seen in Albania and Romania.

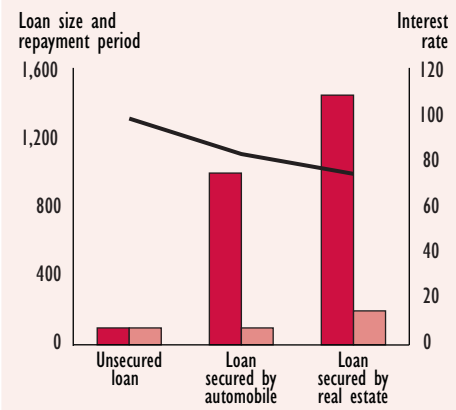
Collateral matters: when businesses use collateral to secure loans, lenders give them better terms. Take the example of Banco Solidario in Bolivia, one of the most successful microfinance banks in Latin America. When borrowers offer collateral, BancoSol provides larger loans (relative to income), longer repayment periods, and lower interest rates (figure 1).[1]

Collateralized loans are the most common lending contract in the formal financial sector. In low- and middle-income countries 70–80 percent of loans require some form of collateral.[2] The same holds true in high-income countries: in the United States, for example, 70 percent of loans are secured by collateral.[3] This makes sense from a lender's perspective: loan contracts can be more easily enforced when secured by property.

Across developing regions, when firms apply for a loan or a line of credit, the most common reason that their application is rejected is insufficient collateral (figure 2). Entrepreneurs recognize this: firms report not bothering to apply for loans because they know in advance that they will be unable to meet the bank's collateral requirements.

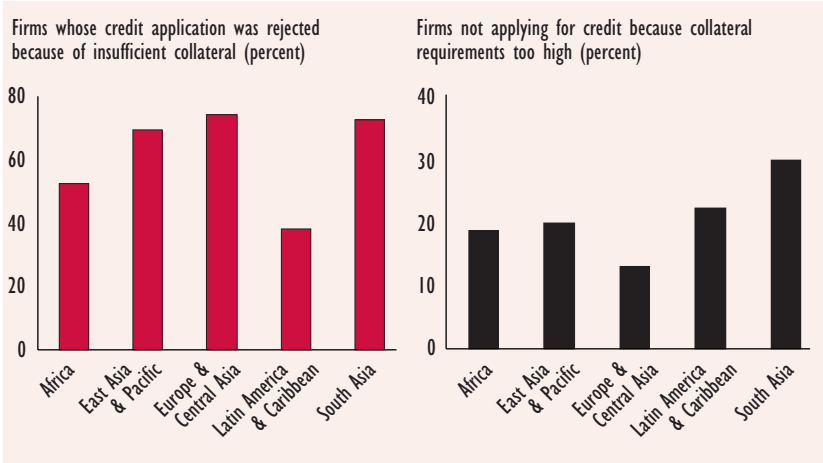
Figure 1 Loans secured by collateral have better terms

Terms on loans from BancoSol for borrowers repaying $870 a month, March 2005 (index: unsecured loan = 100)



Note: Interest rates are derived algebraically from the terms of the loans.
Source: Banco Solidario data (http://www.bancosol.com.bo/en/productos_cr.html).

Figure 2 **Collateral requirements can shut firms out of formal credit markets**



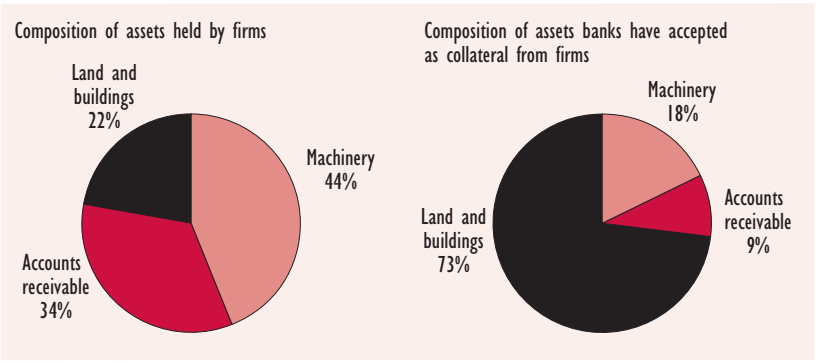
Note: Left-hand chart shows firms whose applications were rejected because of insufficient collateral as a percentage of all firms whose applications were rejected. Data are from surveys conducted in more than 60 low- and middle-income countries in 2001–05.
Source: World Bank Group, Enterprise Surveys database.

Most firms have collateral—but can't use it

Is lack of sufficient collateral truly the reason that firms cannot access finance? Many development specialists and policymakers believe this is so, but it is not true. Firms have assets that could easily be used to secure loans—movable assets such as the goods they produce or process, the machinery they use in manufacturing, accounts receivable from clients, intellectual property rights, and warehouse receipts.

The problem lies in the mismatch between the assets firms own and the assets banks accept as collateral (figure 3). Private firms worldwide hold more than 50 percent of their capital in movable assets rather than in land or buildings. In Canada, New Zealand, and the United States banks consider such assets to be excellent sources of collateral. But in countries where the legal system governing the use of collateral is unreformed, most of the assets that firms hold, especially movable property, cannot be used to secure loans. These assets are "dead capital."

Figure 3 **The assets firms hold are a poor match for those banks accept as collateral**



Note: Data are from surveys conducted in more than 60 low- and middle-income countries in 2001–05.
Source: World Bank Group, Enterprise Surveys database.

The key to unlocking dead capital? Reform

If banks are interested in accepting as collateral property that has economic and market value, why limit them to a narrow range such as land or buildings? Many legal systems place unnecessary restrictions on creating collateral, leaving lenders unsure whether a loan agreement will be enforced by the courts. Where such restrictions mean that only agreements involving certain types of collateral—say, real estate or automobiles—will be enforced, only these assets can effectively serve as collateral for bank loans. Other property—equipment, livestock, leaseholds, accounts receivable—is worthless for this purpose. To take one example, nearly 90 percent of movable property that could serve as collateral for a loan in the United States would likely be unacceptable to a lender in Nigeria.[4]

Uruguay provides another example showing how unreformed collateral systems can severely limit the assets that can secure loans. Wool is a major export and, in principle, excellent collateral for a loan. If the Uruguayan peso depreciated, the dollar price of wool would remain roughly unchanged while the peso price would rise. For this reason Uruguayan banks in the past willingly made loans secured by wool stored in warehouses.

A problem arose when a borrower failed to make payments due and the bank moved to foreclose. The borrower asserted that the wool in the warehouse was not the wool pledged to the bank: "Your wool is gone—it is in sweaters, in rugs. This wool is pledged to another lender." The bank argued that this was absurd, that the bank had renewed for years a loan secured by the firm's wool inventory, wherever it might be found and in whatever state. But the court ruled in favor of the borrower. Uruguay's laws required that the good taken as collateral be specifically identified. The court noted that each bale of wool had an identification number stenciled on it. The bank should have kept track of these numbers and rewritten the pledge of collateral each time the wool rotated—a requirement that meant enor-

mous monitoring costs for lenders (Fleisig, Safavian, and de la Peña forthcoming).

What should reform emphasize?

Canada, New Zealand, and the United States were the first to reform the legal system governing the use of movable property as collateral and now have among the most advanced systems. Low- and middle-income countries have also successfully reformed these systems. Top reformers include Albania, Bosnia and Herzegovina, Romania, and the Slovak Republic. All these countries have several things in common.

No limits on what can serve as collateral

Laws impose no limits on the types of property that can serve as collateral and allow a general description of assets. In Uruguay, allowing a general description of assets would have entitled the lender to the borrower's wool—in whatever incarnation it had taken—or to the proceeds generated by the sale of the wool.

Clarity on which creditors have priority

Secured creditors have first priority to their collateral and its proceeds and can verify their priority through an electronic archive of security filings. Where secured creditors have absolute priority, more credit is available (figure 4). Priority rules work best when a country has a single registry for pledges of collateral, so that prospective lenders can easily establish whether there is a prior claim on an asset. And even if other claimants are given priority—a second best for credit markets—laws can require that their claims be registered in the collateral registry. Ukraine's reform made registering pledges mandatory for all claimants, even the state. If the state fails to register tax liens, it loses priority. That way banks can accurately account for the risk of tax liens against an asset in deciding whether or not to lend.

Rapid enforcement of collateral agreements

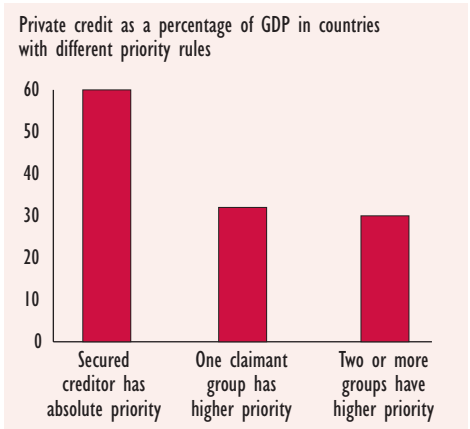
Creditors can seize and sell collateral privately or through summary proceedings, dramatically reducing the time it takes to enforce a collateral agreement. When creditors can seize and sell collateral without resorting to the courts, enforcement can be fast. But when a case winds up in court, summary proceedings, which dispense with many legal formalities to expedite settlement, can also provide rapid enforcement. In a summary proceeding the court requires only a valid collateral agreement and proof of default. In Albania enforcement takes 10 days. Compare that with the one to three years it generally takes in countries with unreformed systems. By that time most movable property will have lost its value.

Bosnia and Herzegovina also introduced a system allowing enforcement of creditors' rights against collateral on presentation to the court of just two documents: the collateral agreement and proof of a valid registration in the pledge registry. The process takes a maximum of 18 days. Moreover, as in Albania, creditors and debtors are free to agree to out-of-court proceedings, reducing time and costs even more.

Two success stories

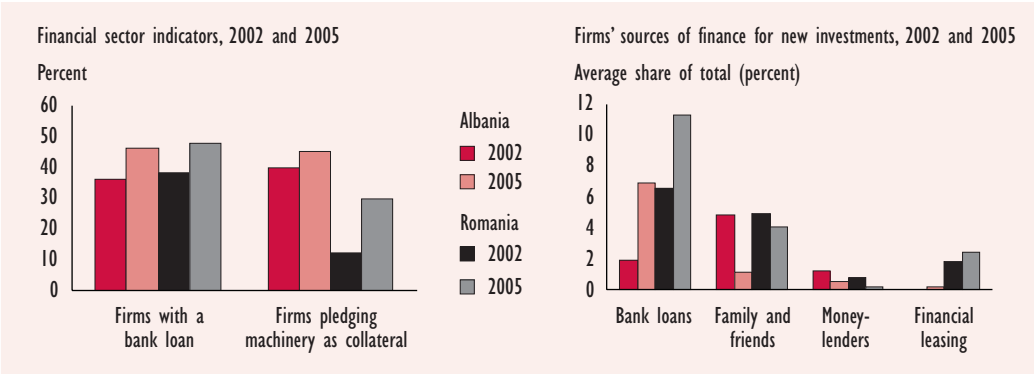
Experience in Albania and Romania shows how reforming collateral systems can have favorable effects in the financial sector (though not all gains discussed here can be attributed solely to the reform). In Albania after a new law governing the use of collateral was passed and a pledge registry set up in 2001, the risk premium on lending fell by half, the interest rate spread by 43 percent, and the interest rate on lending by 5 percentage points. The pledge registry receives around 40 pledges a day on average, and the World Bank Group's Doing Business project now ranks Albania fourth (among 154 countries) on the strength of legal rights for borrowers and lenders.

Figure 4 Absolute priority for secured creditors means more credit for the private sector



Note: Relationships are significant at 5 percent level when controlling for income per capita, growth, enforcement, and credit information.
Source: World Bank 2005.

Figure 5 Reforming the collateral system helped improve access to finance in Albania and Romania



Source: World Bank Group, Enterprise Surveys database.

Romania had a similar experience after it reformed the operation of its pledge registry in 2000: the interest rate spread dropped by 6 percent and the interest rate on lending by 20 percent, while the number of borrowers increased by 30 percent (Chaves, de la Peña, and Fleisig 2004). A 2003 survey suggests that the Romanian registry system is in high demand—with at least 190,000 pledges registered annually.[5]

The situation for firms in Albania and Romania continued to improve between 2002 and 2005. More firms were able to borrow from banks, and the use of movable property as collateral continued to grow (figure 5). How firms financed investments also changed for the better. Firms relied increasingly on commercial sources of finance (bank loans, financial leases) and less on informal sources (family, friends, moneylenders).

Conclusion

Reforms to improve collateral regimes can be an important part of improving access to finance for the private sector. Businesses are not rationed out of credit markets because they lack enough assets to meet the (unnecessarily high) collateral requirements of banks and other lenders. Instead, they are rationed out because the legal framework for collateral prevents them from using their assets to secure loans. Experience in Albania and Romania shows how reforms of the collateral regime can improve firms' ability to finance their operations and investments, helping to generate economic growth and employment where they are most needed.

Notes

1. For more on terms for secured and unsecured loans, see Fleisig, Safavian, and de la Peña (forthcoming).
2. World Bank Group, Enterprise Surveys database.
3. U.S. Federal Reserve Bank, Survey of Small Business Finances, 1998 and June 2006 (forthcoming).
4. Estimate by authors, calculated on the basis of an analysis of secured transactions in Nigeria by Cuming and Baranes (2004) and authors' projections given movable property finance in the United States.
5. European Bank for Reconstruction and Development survey of registries in the Balkans.

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