Secured Transaction Reform: Moving Ahead with Movable Assets

In developing countries, a system that would enable a farmer to pledge cows for a tractor loan from a bank would be a major milestone to economic development because it would increase levels of credit and at the same time decrease the cost. Secured transaction reform (STR) would provide the infrastructure by which movable assets such as cows and inventory could become collateral for bank loans.

In 1971, three teachers who had pooled $1,350 to start a coffee store in Seattle needed additional capital to keep their business running. They ended up borrowing $5,000 from a bank. The start-up that they originally named Starbucks Coffee, Tea, and Spice (now just Starbucks) was able to get the financing it needed to grow and expand, eventually becoming the Fortune 500 company it is today.

Credit is the lifeblood of business. All firms, large and small, need it to grow and thrive. However, access to credit can be constrained, especially in developing countries. According to the World Bank, more than half of private firms in emerging markets have no access to credit. That figure reaches 80 percent in the Middle East and sub-Saharan Africa. Leaders of small and midsized businesses in developing countries may not bother to apply for bank loans because they lack the real estate and land collateral that banks in these countries typically require for a loan. Unfortunately, these banks generally do not view movable assets—which include capital stock, inventory, and receivables—as adequate sources of collateral. In developed economies, the opposite is true. Asset-based lending based on movable property accounts for about 70 percent of small-business financing in these countries, according to a 2010 study by the World Bank's International Finance Corporation.

Consequently, secured transaction reform (STR) that would provide the legal and institutional infrastructure through which movable assets can be used for lending to small businesses would represent a major milestone in developing countries. In other words, a system that would enable a farmer to pledge his cows for a tractor loan or a merchant to pledge her inventory to expand her business would contribute to economic development by increasing levels of credit and decreasing its cost.

In July 2012, leading experts and practitioners from the Americas met at the Atlanta Fed to discuss experiences with STR, best practices, and ways to promote STR throughout the western hemisphere. (To view the conference presentations go to iamericas.org/STR/.) In his opening remarks at the conference, Ambassador Charles Shapiro, president of the Institute of the Americas, noted that for STR to occur, nations need both a legal framework, with laws on secured transactions that allow borrows and lenders to recognize movable assets as collateral, and an effective collateral registry that would contain information about these assets.

Laying down the law

With respect to the legal framework, Professor Boris Kozolchyk of the National Law Center for Inter-American Free Trade said that a few essential changes to statutory law are necessary. First, he noted, countries need secured transaction law (STL) to replace the mostly 19th- and early 20th-century code provisions or individual statutes on trade. These countries also need to adopt an e-commerce law to make sure that what formerly could only be stated in a binding fashion by means of a paper-based document can be said by means of an electronic document, message, or record. They need a bankruptcy law that does not undermine the banks' ability to collect. Finally, Kozolchyk said, the STL must include legislation (or there should be independent statutes) recognizing negotiable electronic warehouse receipts and bills of lading (including truck, air, and sea waybills) as well as manuals of best practices for lending (including "blue books" to establish the value of various types of collateral).

The creation of electronic registries is another essential step, according to Kozolchyk. Movable assets, whether tangible or intangible, are a large part of a firm's capital stock. Once a legal framework is in place, a publicly accessible registry that can provide notice of interests in movable assets and that can establish priority in these assets is essential.

Buying in

Kozolchyk warns that the work is not done even when these reforms are in place. Behavioral changes must also occur—lenders and borrowers must be willing to learn a new form of lending. Bankers, for example, will need to realize that the inventory and accounts receivable that their steady and reliable account debtors owe is usually more liquid collateral than real estate and therefore more valuable. They must be willing to give consideration to small and micro-businesses that show an ability and willingness to repay. In areas where tax evasion is common, borrowers will need to disclose their income to their creditors, according to Kozolchyk.

Pioneers Show Progress on Secured Transaction Reform

A number of developing economies around the world have implemented secured transaction reform. Their success can be quantified using a variety of measures.

China

In 2007, China instituted major STR reforms, which included new laws on property and a new registry that the International Finance Corporate (IFC) notes has key modern features, including online access, user accounts, centralized information, reasonable fees, and a notice-based registry with information on the creditor, debtor, loan amount, and asset description. According to the IFC, several advances resulted.

More loans with movable assets: Commercial loans involving movable assets rose 21 percent per year in the three years following the reform. Four of China's largest banks reported an average of 25 percent compound annual growth rate increase in movables lending.

Expanding registry: From the beginning of 2008 to June 2011, the registry recorded 385,000 registrations worth $3.5 trillion.

Spillover: Important spillover effects include the growth of leasing transactions and factoring, which increased from 2.6 billion euros in 2003 to 67.3 billion euros in 2009.

Romania

A study by the Center for the Economic Analysis of Law and the World Bank in September 2004 notes that Romania's reform of the operation of its pledge registry in 2000 resulted in several effects benefiting small and medium enterprises (SME).

Growing filings: Romania archived 65,000 filings in 2001, a number that rose to 171,000 in 2002 and then to 190,000 in 2003.

More credit: The total volume of private bank credit rose $4.8 billion between 2000 and 2003, increasing as a share of GDP from 11.3 percent in 2000 to 15.8 percent by 2003.

Better access to credit: By the end of 2003, borrowers had filed 426,000 security interests. At the same time, the number of borrowers at the Romanian central bank had grown from 18,672 in 2000 to 73,357 in 2003.

Growing loan size: If the 426,000 security interests were responsible for the entire increase in private credit of $4.6 billion that would imply an average loan size of about $10,800. This is considerably lower than the average loan size of $73,301.

Ghana

After passage of the Borrowers and Lenders Act of 2008, Ghana set up a collateral registry at the Bank of Ghana. According to the IFC, the change had several beneficial results.

Increased volume of financing for SMEs: More than 20,000 loans have been registered by banks and nonbanking financial institutions in the collateral registry since its creation in March 2010, accounting for more than $800 million in financing secured with movable property.

Wider use of movable assets as collat-

When borrowers do this—understanding that it is to their financial benefit to do so even if it means they will pay taxes—a positive change in the business and legal culture can also take place.

The type of registry adopted under STR can help support some of this change. Results of a recent World Bank survey suggest that countries with registries that are free or relatively cheap and easy to use tend to have more registrations (and more loans). The survey, which found 21 jurisdictions reformed their secured transaction laws between June 2010 and June 2011, looked at how these countries' registries measured up to international standards. It found that many that started with paper-based registries are now making online searches possible. It also found that in 60 percent of the countries, online searches are free or cost less than $5. With respect to registration, some countries require that actual documents be registered while others require only a notice registry that provides information about the documents. A notice registry is considered more efficient for registering a security over movable assets, according to best practices outlined in the survey report. Some countries use a sort of hybrid system, with both paper and electronic registration; online is considered a best practice.

ECONSOUTH NOW PODCAST

Charles Shapiro of the Institute of the Americas and Boris Kozolchyk of the National Law Center discuss secured transaction reform. On frbatlanta.org, select "Podcasts."

Honduras: A shining star

Honduras is considered to be one of the great successes of STR, and the efficiency of its registry is one of the reasons, says Marek Dubovec of the University of Arizona's James E. Rogers College of Law. According to Dubovec:

> The Honduran registry was the first in Latin America to take into account the specific needs for ease of access, transparency, quickness and accuracy of filing by a) enabling a two-fold method of filing, i.e. paper-based documents and electronic messages or records, b) eliminating

eral by businesses: Whereas real estate was once the chief source of collateral, it now accounts for only 10 percent of collateral for SMEs. Other collateral sources include inventory and accounts receivable (for 32 percent of the loans); investment instruments such as shares, cash, bonds, and deposit accounts (19 percent); household assets (13 percent); motor vehicles (10 percent); real estate property (10 percent); and machinery, equipment, all enterprise assets, and other (16 percent).

Mexico

The creation of the new centralized web-based collateral registry provides a system that allows for all types of online transactions (registrations, searches, amendments, cancellations, and payments). It has also reduced registration time from 17 days to mere seconds and eliminated the registration fee, which was an average of 2 percent of the value of the loan. The IFC notes many other benefits.

Increased financing for SMEs: The country's new registry has resulted in the number of loans to businesses increasing by a factor of 5, to around 32,000 in October of 2011. These loans have generated more than $110 billion in financing to businesses, with SMEs accounting for more than 90 percent of the firms receiving those loans.

Reduced cost of credit: The reform has also led to a cumulative estimated saving for borrowers of $2.1 billion in registration fees associated with the registration of the security interest in the previous system.

Wider use of movable assets as collateral: The types of collateral used by SMEs include agricultural products (in 49 percent of the loans); machinery and equipment (24 percent); motor vehicles (13 percent); livestock (4 percent); accounts receivable (2 percent); investment instruments such as shares, cash, bonds, and deposit accounts (1 percent); consumer products (1 percent); inventory (1 percent); and others (5 percent). ▮

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the traditional evaluation of submitted documents by automating the process of recording, and c) limiting the recording requirements to summary financing statements.

The Honduran registry has made it easy for individuals and businesses to create security interests, and secured creditors can identify borrowers in filings through borrowers' national ID numbers. This system of user accounts provides a secure method of access. The Honduran registry is also connected to the registries for car titles and to business associations, which reduces the risk of input errors and provides protections to not only secured creditors but also bona fide purchasers of goods.

The affordable cost of credit

Alejandro Alvarez de la Campa of the World Bank's International Finance Corporation noted that countries that have created a modern electronic registry and implemented secured transaction reform see the cost of credit for some borrowers decrease in two different ways. First, business owners who were borrowing from informal microlenders at high interest rates—which vary from country to country but are usually more than 40 percent—gained access to secured loans from commercial banks at much lower interest

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rates, using their movable assets as security. Second, the costs and fees associated with creating a security also drop.

Alvarez de la Campa pointed to Mexico's experience to illustrate these gains. Mexico eliminated taxes and notary fees, leaving only a small, flat registration fee. Mexico's Ministry of Economy noted that since the start of the secured transaction registry in October 2010, borrowers have pledged more than $190 billion in collateral. Because each borrower no longer had to pay the registration tax of up to 2 percent per loan amount, the ministry projects that total savings could be more than $3.8 billion dollars.

On the horizon

A number of nongovernmental organizations (NGO), government agencies, and international financial institutions—including the Institute of the Americas, the United States Agency for International Development, the United Nations Commission on International Trade Law, and the World Bank's International Finance Corporation—have made STR a priority. These organizations are seeking to convince lawmakers, financial institutions, and borrowers that STR can help expand access to credit and promote economic growth in the developing world.

The momentum is building, as more and more countries implement STR (see the sidebar). Those countries that have gone through the process are creating blueprints for those countries who have yet to do so. The Congress of the Republic of Colombia is expected to pass an STR bill before the end of 2012, according to Luis Guillermo Vélez, the Colombian Superintendent of Companies. Shapiro also identified other countries making significant progress. In El Salvador, the Ministry of the Presidency approved a draft bill that had been pending review. Guatemala has favorable law already in place, and is pursuing changes in registrations and associated fees to promote lending. Jamaica, Panama, Costa Rica, and Haiti are all making positive early steps in the STR process.

For these and many other countries, the question may be shifting from *whether* they will adopt secured transaction reform to *when*. ∎

This article was written by Stephen Kay, director of the Atlanta Fed's Americas Center, and Ed English, a staff writer for EconSouth.

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two state prisons—at the request of its owner, the Alabama Department of Corrections. At a stroke, the annexation also added 3,000 people to the city's former population of 7,000.

Waiting for Airbus

Financing the business park has forced the city to trim services such as paving streets and purchasing new police cars. "It's hard for some people to understand that because they see potholes and things and say, 'You're taking our money and putting it in places it doesn't need to be.' But it's coming," Shell said of Rivercane's prospects. "I think another five years will make a tremendous difference."

By then, the European aircraft manufacturer Airbus is scheduled to be assembling jets in Mobile, 57 miles away. Atmore leaders hope Rivercane will attract suppliers to the massive Airbus plant. In the shorter term, Shell foresees a wellspring of tax revenue from businesses near the interstate and casino. As a model for roadside economic development, he looks 75 miles north to Greenville, Alabama, where restaurants and stores have crowded interstate exits. That commercial cluster, Shell said, accounts for the bulk of the city of Greenville's tax revenue.

Roots in the soil

Aside from the casino, Atmore's economic profile is typical of rural southern towns. Education and income levels are lower than state and national norms, while the poverty rate is higher, according to 2010 U.S. Census Bureau figures. Surrounded by pine forests and farmland, Atmore's economy historically was rooted in timber, agriculture, and some manufacturing. The city hall, in fact, is on the site of an old sawmill, next to railroad tracks that were responsible for the town's birth.

Also like many southern towns, Atmore a decade ago lost a cut-and-sew textile operation that had been the city's largest employer. VF Corporation (Vanity Fair) in 2001 closed a women's undergarments plant, costing Atmore 509 jobs, according to state records.

Even today, despite visitors flocking to Wind Creek, Atmore's quaint downtown struggles with vacancies. Shell noted that vehicle traffic at times is so heavy pedestrians have to cross Main Street only at red lights. This was not the case before Wind Creek.

Yet few casino patrons stop to spend time and money downtown. Indeed, a booming retail trade five miles north of downtown is a mixed blessing. "Everything's moving toward the interstates," Vickery said. "We have to rethink our downtown. Your heart is your downtown. If your downtown goes, your community goes." ∎

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