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## FOREWORD

In the wake of the Asian financial crisis, the Asian Development Bank (ADB) sponsored and financed two regional technical assistance studies. These were a regional technical assistance on insolvency law reform (TA No. 5795-REG) and a regional technical assistance on secured transactions law reform (TA No. 5773-REG). A report on insolvency law reforms in the Asian and Pacific region and an article on “The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms”, was published in April 2000 as the first volume of the 2000 edition of the Law and Policy Reform at the ADB. This second volume of the 2000 edition of the Law and Policy Reform at the ADB comprises a major study on secured transactions law reform based on the findings of ADB’s regional technical assistance (TA No. 5773-REG)(RETA) studying the People’s Republic of China, India, Pakistan, Thailand and Indonesia (the RETA countries).

The RETA recognizes that, notwithstanding the multifaceted importance of secured transactions law reform, there is no international “best practice” or universally adopted standard for secured transactions regimes among developed countries. Consequently, the thrust of the RETA is to provide a comprehensive and deliberative analysis of the elements that would form the foundation of a secured transactions regime that can effectively promote the economic benefits of secured transactions law reform. This study also highlights the need to consider competing economic and social interests and the institutional context in developing countries in the Asia and Pacific region. The RETA’s multidisciplinary approach to legal analysis in a cross-section of common law and civil law jurisdictions, combined with empirical economic research, in the RETA countries is designed to contribute to an informed debate on secured transactions law reform.

We are pleased with the progress achieved to date on this project and its continuing contribution to improving and enhancing the legal systems of ADB’s developing member countries. We are fully committed to pursuing such law and policy reform initiatives that are welcomed by ADB’s developing member countries and actively engaging with them in this critically important work.

Gerald A. Sumida  
General Counsel

December 2000

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## PREFACE\*

1. Among the various reforms identified in the aftermath of the Asian financial crisis, secured transactions law reform has been highlighted and some countries, such as Indonesia, have embarked on a process of reforming their secured transaction regimes. Yet, as the ensuing study shows, there is no single model of a secured transactions legal regime and there are wide variances among developed countries in Europe and North America. Consequently this is not an area where one can refer glibly to common law rules, general standards or global “best international practices”. Instead reform of secured transactions regimes in developing countries needs to be carefully tailored to the legal tradition of each country and should be designed to achieve the particular economic and social policy choices that policy makers in each country wish to pursue. Such policy choices, however, need to be preceded by an informed debate on the key issues involved.<sup>1</sup> This Preface seeks to highlight a few areas of relevance to this debate.

### A. The Importance of Secured Transactions Law Reform

2. Economic growth is recognized as an important goal of development and increasingly so in the fight against poverty even though the debate has shifted to the quality of growth and its outcomes.<sup>2</sup> The role and importance of small and medium sized enterprises (SMEs) to sustainable economic growth is also well established. It is, therefore, not surprising that soon after commencement of its operations ADB’s financial sector operations focused on providing credit for SMEs.<sup>3</sup> As developing countries adopt market oriented economic policies, the need to establish sustainable market-based incentive systems for provision of credit by the private sector to SMEs is greater than ever before. While no comprehensive survey of constraints for SMEs in the Asia and Pacific region has been carried out “a large enterprise survey conducted in 1999 by the World Bank and EBRD has concluded that access to finance is still one of the central problems for SMEs in transition economies.”<sup>4</sup> As Chapter III of this study explains, the creation of a legal framework that allows a creditor to take a security interest over a debtor’s movable property is the key to SME’s access to readily available, cheap and long-term credit. This is all the more so as SMEs, unlike larger enterprises, are likely to have less immovable property (land and buildings thereon) that can be offered as collateral to secure loans from creditors. Unleashing the economic potential of movable property as collateral, while leaving it in the hands of the debtor for productive use, is therefore the main focus of this study. It is the contention of this study that tapping of this economic potential requires development of effective and efficient legal frameworks that facilitate secured transactions.<sup>5</sup>

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\* Authored by Arjun Goswami, Counsel, in collaboration with Hamid Sharif, Senior Counsel, Office of the General Counsel, ADB.

<sup>1</sup> See Harold D. Lasswell & Myres, S. McDougal, *Jurisprudence for a Free Society: Studies in Law, Science and Policy* (1992).

<sup>2</sup> *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the ADB*, October 1999, paragraph 4, and Vinod Thomas et al, *The Quality of Growth*, 2000 (Published for the World Bank by OUP).

<sup>3</sup> Soon after commencement of operations in 1967, ADB made a loan to Korea for SMEs in 1969 (Loan No. 23 KOR First Medium Industry Bank) and by 1989 it had made another eight loans for SMEs.

<sup>4</sup> Muent & Pissarides, "Impact of collateral practice on lending to small and medium sized enterprises", *EBRD Law in Transition*, Autumn 2000; EBRD, *Business Environment and Enterprise Performance Survey, Transition Report 1999*.

<sup>5</sup> For a definition of the term “secured transactions” see the Glossary.

3. The Asian financial crisis has underscored the vulnerability of financial systems when the sources of credit are concentrated in the banking system and not diversified. A factor contributing to this concentration of bank credit is the inability of the legal system to allow other potential creditors, such as suppliers of goods, to take effective security over movable property, or to use their inventories, accounts receivable and chattel paper as collateral for credit. This limits the sources of refinancing available to such suppliers and, in turn, their role as a source of credit. Secured transactions law reform can foster more robust financial systems by encouraging credit diversification, reduced dependence on bank credit, and less reliance on real estate collateral. The adverse consequence of such constraints on non-bank creditors was highlighted in the G-22 Report on International Financial Crises of October 1998 which declared that, "*Recent experience shows that financial systems which are heavily dependent on banks can experience financial instability of a magnitude that can generate macroeconomic difficulties ... Effective debtor-creditor regime laws [including a framework for secured transactions] create a legal framework that allows loans to be extended at lower interest rates at less risk while facilitating the diversification of credit risk and fostering non-bank financial intermediation. Reduced dependence on bank credit lessen the economic impact of a banking crisis on the real economy ...*". In addition, better use of movable property collateral may help to somewhat reduce the bias towards real estate based lending by banks and assist in limiting the adverse consequences for the financial system resulting from bursting of real estate speculation bubbles.

4. One of the consequences of the constraints on the availability of movable collateral for financing in emerging markets is the way in which such constraints interact with constraints on the availability of international collateral (i.e. export revenues) that international creditors can seize in the event of loan defaults. This exacerbates systemic risk since as a result of these constraints there is insufficient collateral cushion for creditors in a crisis.<sup>6</sup> Thus Caballero and Krishnamurthy state, "*firms in an economy with limited domestic collateral and a binding international collateral constraint will not adequately precaution against adverse shocks, increasing the severity of these shocks.*"<sup>7</sup> The legal constraints on the availability of movables as domestic collateral can in part explain why domestic firms in emerging markets make choices that lead to contracting of excessive foreign currency debt that increases the vulnerability of emerging markets to foreign currency risks. Removing constraints to the use of collateral by reforming secured transactions regimes can therefore help to reduce the systemic risk that this may pose.

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<sup>6</sup> Caballero and Krishnamurthy, *International and Domestic Collateral Constraints in a Model of Emerging Market Crises* (Massachusetts Institute of Technology, Department of Economics, Working Paper Series, September 2000), Abstract.

<sup>7</sup> Caballero and Krishnamurthy, *International and Domestic Collateral Constraints in a Model of Emerging Market Crises* (Massachusetts Institute of Technology, Department of Economics, Working Paper Series, September 2000), Abstract. Although the Caballero and Krishnamurthy article focuses on real estate domestic collateral, the same argument can be extended to movables collateral.

5. Securitization<sup>8</sup> can provide alternative sources of finance for enterprises especially given the constraints on bank borrowings and capital markets. It also has benefits for the creditors since the credit risk of the originator is separated from the credit risk relating to the portfolio in question (which is rated higher than the originator). Success of securitization as an alternative source of financing is, however, premised on secured transactions regimes that allow for the effective creation, perfection and enforcement of security interests in receivables. Thus the legal regime in Japan governing the perfection of the assignment of receivables was a major impediment to the development of a securitization market in Japan for years because under the Civil Code notice through a notarially certified date stamp was required to perfect an assignment against third parties. This resulted in significant logistical and transactional costs when a large number of receivables were to be assigned. It was only in 1998 that the Law Prescribing Exceptions to the Requirements for the Perfection of Assignment of Receivables under the Civil Code (Law No. 104 of 1998) was enacted that allowed perfection of assignment as against third parties by filing a registration statement with the Legal Affairs Bureau.<sup>9</sup> In Thailand the creation of a security interest in movable property through a conventional pledge under the Civil and Commercial Code (CCC), which is effected by delivery of the pledged property to the custody of the pledgee or custodian, could not support securitization since the SPV's main assets were receivables. Yet even if creation of such security interests may have been addressed through the Securitization Act of 1997 in Thailand the continued use of novation<sup>10</sup> as a means of asset transfer as governed by the CCC may not be practicable for securitization because the assets to be securitized require collection from a large number of debtors.<sup>11</sup> Such examples underline the need for policymakers in Asian DMCs to carefully evaluate whether comprehensive secured transactions law reform or attempts at piecemeal reform on securitization in isolation better serve the need to reduce time and costs in structuring securitization transactions. A better approach may be to adopt a coordinated or sequenced approach to secured transactions and securitization law reform. As outlined below, the potential of securitization may go much beyond traditional corporate transactions to supporting microcredit.

6. Effective secured transactions laws have the potential to provide microfinance institutions with greater access to credit and thereby indirectly alleviate poverty. Poverty alleviation is likely to be a matter of particular concern to policymakers in Asian developing countries given that *"close to 900 million of the world's poor (i.e. those who survive on less than \$1 a day) live in the Asian and Pacific region. South Asia, one of the poorest subregions in the world has more than half a billion poor people of whom 450 million are in India. The People's Republic of China has 225 million poor and about*

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<sup>8</sup> Securitization is the repackaging of a revenue stream into tradable securities that are issued to third parties. Securitizations can be structured through the sale by an originator of a receivable (any legal entity which has receivables like trade receivables or receivables on loans) of some reasonably predictable cash flow in the receivables to a special purpose vehicle (SPV) which then funds the purchase through issuance of securities. The credit risk on the receivables is separated from the credit risk of the originator by ensuring that the securities backed by the receivables are rated more highly than the originator. For a definition of the term "securitize" see also the Glossary.

<sup>9</sup> Christopher Lewis, "Securitization of consumer loan receivables in Japan", *The Asian Securitization and Structured Finance Guide 2000*.

<sup>10</sup> "Novation" is a substitution of a new contract, debt or obligation for an existing one between the same or different parties. A novation may substitute (i) a new obligation between the same parties; (ii) a new debtor; or (iii) a new creditor. *Black's Law Dictionary (7<sup>th</sup> Edition 1999)* at 1091.

<sup>11</sup> W. Chittmitrapap, "Legal aspects of asset securitization in Thailand", *The Asian Securitization and Structured Finance Guide 2000*.

55 million more are in Southeast Asia, where in the wake of the Asian crisis, over 10 million have joined the ranks of the poor.”<sup>12</sup> Whilst there is a paucity of studies on the impact of secured transactions law reform on microcredit in Asia, a useful study on securitization of microenterprise portfolios in Ecuador provides a compelling analysis of the type of benefits that could accrue to microlending as a result of securitization.<sup>13</sup> The Ecuador study showed that a microfinance finance institution (BancoSol) that directly accessed capital markets by securitization of its accounts receivables was able to increase its loan portfolio by a factor of 25 over the period 1992 to 1994. In comparison, another microfinance institution that did not use securitization, Fundacion Ecuatoriana de Desarrollo (FED), achieved a 16 fold increase in more than twice the time period from 1989 to 1994. In the Ecuador case securitization of microenterprise loan portfolio involved the creation of a single purpose corporation (SPC) which bought the microenterprise portfolio from the microcredit provider (BancoSol) and capitalized itself by issuing debentures backed by the microenterprise portfolio in the capital markets. Such a structure yields benefits not merely in terms of greater access to external credit but also additional earnings for the microcredit provider<sup>14</sup> which can be used to finance an expansion of microlending. However, for securitization of microfinance institutions to succeed it is important to have a secured transactions regime that allows for the effective creation, perfection and enforcement of movable property collateral in the form of receivables of the microenterprise portfolios. While success of microcredit is related to many other factors (such as recoveries made etc.), secured transactions law reform has the potential to provide a link between the informal and formal financial sectors by fostering the securitization of microenterprise portfolios to enable microfinance providers to address their funding constraints.

7. Secured transactions law reform also has the potential to strengthen corporate governance through better monitoring and disciplining of management by creditors. In Asia the need for companies to be run transparently and for management to be held accountable has been the focus of particular attention in the aftermath of the Asian financial crisis. Asian policymakers have recognized the importance of good corporate governance as an important tool to ensure that the management of companies do not ignore the logic of the marketplace and respond in a timely and responsive fashion to the pressures of consumers and investors alike. In many crisis affected economies creditors were ineffective monitors of corporate managers. In common with many other parts of Asia, companies in the crisis affected countries were often family-owned, even when publicly listed, and this made the absence of effective creditor monitoring of corporate governance particularly acute. Whilst acknowledging the close relationship between banks and the corporate sector due to which banks showed little regard to future debt servicing capacity of borrowers when making loans, a weak legal and judicial system contributed to poor creditor monitoring as it provided little leverage to creditors when dealing with debtors.<sup>15</sup> Creditors can and appropriately should play a crucial role in corporate governance. There is a critical link between banks and firms in terms of survival given that creditors ultimately depend for their survival on debt repayments from their debtor-firms. As one commentator has remarked, “*Debt appears to be slowly*

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<sup>12</sup> *Fighting Poverty in Asia and the Pacific : The Poverty Reduction Strategy of the ADB*, October 1999, paragraph 2.

<sup>13</sup> Michael Chu, "Securitization of a Microenterprise Portfolio", *Key Issues in Microfinance*.

<sup>14</sup> Michael Chu, "Securitization of a Microenterprise Portfolio", *Key Issues in Microfinance*, states that before securitization the microlender had earnings per loan of 8% whereas after securitization the microlender had earnings of 14% amounting to additional earnings of 5%.

<sup>15</sup> Mark Baird, "Transparency and Corporate Governance", World Bank, 25 April 2000.

*emerging as a device for exerting control over medium and large enterprises in some transition economies. The powers and incentives of creditors in these countries are still weak, however, compared with their counterparts in more mature market economies ... While control by equity holders is appropriate in profitable times (when entrepreneurial risk taking is needed), creditor monitoring and control becomes binding in times of financial distress, particularly when tight controls on spending and investment are needed.*<sup>16</sup> Whilst there has been a good deal of analysis of corporate governance control by equity owners, there has been relatively little analysis of the equally important legal and institutional requirements for effective creditor monitoring. Secured transactions laws, which are a critical part of the legal framework for debt collection, play a crucial role in the legal underpinning of such creditor monitoring. This is because although one aspect of creditor monitoring is the evaluation of firm operations and investments, a second equally important aspect depends on collateral for security. In fact analysis of the value of that collateral must precede any lending decision so it is incorrect to regard collateral security as an inactive or passive means of control as opposed to cash flow analysis. Thus commentators have recognized that the legal framework for debt collection is one of the crucial lynchpins for creditor monitoring.<sup>17</sup> Although such commentators have focused on Eastern Europe and not on Asia, the logic of this argument should be carefully considered by policymakers in Asia in their efforts to promote corporate governance.

8. As developing countries, such as India and the Peoples' Republic of China, expand into the domain of the 'new economy', secured transactions regimes will become even more important for their economies. The promotion of robust secured transactions regimes can play a potentially useful part in helping to mitigate the digital divide between technology companies in developed and developing countries. This is because the value of "new economy" companies is typically based on intangible assets like intellectual property in software programs rather than tangible assets.<sup>18</sup> Whilst other sources such as venture capital will be of importance to new economy companies in developing countries seeking to obtain credit, the effective use of intangible assets as collateral is likely to be a key element of access to credit by such technology companies. In addition, to the extent that such companies are start ups in the SME sector, the factors adversely affecting SMEs in the absence of an effective secured transactions regime will also affect small and medium sized technology companies.

## **B. Regional Foundations of Secured Transactions Law Reform**

9. In the 1970s and 1980s the United Nations Commission on International Trade Law (UNCITRAL) attempted global unification and harmonization of secured transactions law. However, at its 13<sup>th</sup> session in 1980 UNCITRAL concluded, "*that world wide unification of the law of security interests in goods ... was in all likelihood unattainable.*"<sup>19</sup> This conclusion, based in part on the wide divergences among different legal systems amongst developed countries, had two effects. At the global level unification and harmonization efforts were scaled down to more limited conventions on

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<sup>16</sup> Cheryl Gray, "Creditors' Crucial Role in Corporate Governance", World Bank, *Finance & Development*, June 1997.

<sup>17</sup> Cheryl Gray, "Creditors' Crucial Role in Corporate Governance", *Finance & Development*, World Bank, June 1997.

<sup>18</sup> Bank of England, *Finance for Small Firms, A Sixth Report*, London January 1999.

<sup>19</sup> Report of the Secretary General of UNCITRAL on "Security Interests" to 33<sup>rd</sup> session of UNCITRAL A/CN.9/475 dated 27 April 2000 *UNCITRAL Report on Security Interests*, paragraph 5.

specific financing techniques based on security interests<sup>20</sup> while at the regional level it spawned broader attempts at harmonization of secured transactions law.

10. The enforcement of certain types of security interests for high value transactions between debtors and creditors in developing countries under the limited conventions being developed by UNCITRAL and Unidroit may spurn reform of secured transactions regimes generally.

11. As the broad based work on secured transactions reform has increasingly become the province of regional development, such regional work may ultimately provide a 'bottom up' approach to global harmonization of secured transaction law and lead to a nuanced, regionally attuned development of viable principles compatible with the process of globalization. It is likely that the more globalization progresses, the more opportunity for diversity will develop. The fundamental premise for such diversity is respect for freedom of choice through participation in social processes. Such respect is the empirical basis of regional diversity. A non exhaustive list of significant regional developments on secured transactions reform includes the 1994 Model Law on Secured Transactions of EBRD,<sup>21</sup> the 1997 Uniform Act on Security Rights based on French law by the Organisation pour l'Harmonisation en Afrique du Droit des Affaires (OHADA) and the current work of the Organization of American States (OAS) on the preparation of a model inter-American law on secured transactions.<sup>22</sup>

12. The ADB is seeking to contribute to these regional developments on secured transactions by promoting secured transactions law reform appropriate for the Asia and Pacific region with its wide diversity of common law and civil law jurisdictions and cross section of transition and liberalizing economies.

### **C. Challenges Facing Secured Transactions Law Reform**

13. This analysis begs the question that if secured transactions law reform presents so many compelling economic benefits and there is an increasing impetus by development agencies as well as developing countries' policymakers to rally to the banner of such reform, why has it not taken place as yet? Any institutional reform process faces a variety of challenges and obstacles that must be tackled. The pace of reform in developing countries in this respect is not unusual as each country tries to craft solutions that are best suited to its circumstances.

14. An institutional reform is shaped by a number of formal and informal constraints. Some of these constraints may be historical, social or cultural and the reform process will be "path dependent".<sup>23</sup> As some of the latest thinking on comparative institutional analyses acknowledges, no single institution or pattern of reform is optimal and "[t]here are no purely rational decisions, ideal institutions, or optimal solutions, but only second

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<sup>20</sup> Examples of limited conventions on certain aspects of security interests based financing which have been or are being developed include UNCITRAL's draft Convention on Assignment of Receivables and the International Institute for the Unification of Law (Unidroit) draft Convention on International Interests in Mobile Equipment, Unidroit's 1988 Convention of International Financial Leasing and Unidroit's 1988 Convention on International Factoring.

<sup>21</sup> As a result of its experience on adoption of the Model Law, EBRD has since developed a set of ten core principles on security interests (*UNCITRAL Report on Security Interests*, paragraph 15).

<sup>22</sup> *UNCITRAL Report on Security Interests*, paragraphs 13 and 14.

<sup>23</sup> Douglas North, *Institutions, Institutional Change, and Economic Performance* (Cambridge University Press, 1990).

bests".<sup>24</sup> It is, therefore, not surprising that secured transaction law reform in some developed jurisdictions has also been slow even though the existing secured transactions regimes in these countries would be found wanting if measured against the benchmark of the baseline for effective secured transactions regimes outlined in the ensuing study. For example in the United Kingdom, where the reform of secured transactions law has been pending since the Diamond Report of 1988,<sup>25</sup> such reform has yet to occur. In early 1993 the Australian Law Reform Commission (ALRC) made a report<sup>26</sup> recommending substantial reform to personal property security interest laws based in part on overseas experience in North America, the United Kingdom's Diamond Report and a 1989 report of the New Zealand Law Commission. To date none of the recommendations of the ALRC have been adopted in Australia. As familiarity with existing laws has been preferred over new laws that may be more rational and efficient. The reasons for delay in secured transactions law reform may also lie, in part, in the fact that implementation of secured transactions law reform cannot be done in isolation but must take account of a variety of other laws such as property, insolvency<sup>27</sup> or civil procedure. This becomes particularly acute in developing countries where issues about existing legal frameworks are compounded with concern about legal transplants being grafted onto the body of existing local laws.<sup>28</sup> Secured transactions law reform and the accompanying institutional change, therefore, requires patient and sensitive consensus building to address genuine concerns. Concerns raised by vested interests that gain from the relative lack of transparency of existing systems and the fees that can be gained from inefficient secured transactions regimes, also need to be countered.

15. Social concerns arising from a system that allows creditors to seize assets and sell them to recover their dues also need to be addressed. Unscrupulous and heartless money lenders are part of or have been a part of social reality or folklore in many countries. In some countries the impression of fire sale of assets in the aftermath of the Asian financial crisis may have added to these apprehensions. There may be genuine concerns that secured transactions law reform is designed to simply strengthen the hand of secured creditors at the expense of vulnerable social groups such as unemployed workers, small consumer borrowers or that such laws oppose the reincarnation or resurrection of companies through corporate rehabilitation. In fact as the ensuing report shows the critics of secured transactions law reform have no monopoly on social compassion. Holistic and integrated secured transaction law reform is deeply concerned with protecting the rights of other interests but seeks to do so within the context of a robust secured transactions regime that maximizes the economic benefits of secured credit for the economy.<sup>29</sup> No balanced advocate of secured transactions law reform would propose reform that did not pay attention to basic consumer protection. Thus in the United States the secured creditor friendly Uniform Commercial Code (UCC) Article 9 coexists with the Fair Debt Collection Practices Act 15 U.S.C. Section 1692 and the

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<sup>24</sup> Edward L. Rubin, "The New Legal Process, the Syntheses of Discourse, and the Microanalysis of Institutions", *109 Harvard Law Review* 1393, 1411 (1996).

<sup>25</sup> A.L. Diamond, *A Review of Security Interests in Property* (DTI, HMSO 1989).

<sup>26</sup> ALRC Report No. 64.

<sup>27</sup> "The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms", *Law and Policy Reform at the ADB, Vol. I, 2000 edition*.

<sup>28</sup> Catherine Walsh, "The 'law' in Law and Development", *EBRD Law in Transition*, Autumn 2000.

<sup>29</sup> "The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms", *Law and Policy Reform at the ADB, Vol. I, 2000 edition*. Though this essay was confined to the relationship between corporate insolvency and the rights of secured creditors, an integrated approach should also seek to balance the different interests of secured creditors and individuals and non-corporate business enterprises facing insolvency.

Consumer Credit Protection Act 15 U.S.C. Section 1601 that, among other things, restrict the garnishment on wages of workers. The overwhelming focus on corporations and corporate rehabilitation in recent years ignores the fact that secured transactions law reform is designed to assist SMEs that often consist of individual entrepreneurs or non-corporate entities, and prevent use of personal guarantees that can lead to the personally devastating and commercially ill suited consequences of debtor imprisonment.

16. Enthusiasm for much law reform in developing countries often wanes in the face of the poor institutional context in which laws are enforced. As ADB has noted, enactment of laws is the easiest part of a process of systemic reform and the real challenge is to bring about institutional change that can credibly enforce the new laws and in turn change behavior.<sup>30</sup> Developing countries pay a heavy price for lack of confidence in the ability of the formal legal system to efficaciously and efficiently settle disputes. Deficiencies in the formal legal system does not of course mean that business transactions come to an end. However, transaction costs are higher and choice of parties is effectively limited as it is based on reputation of and relationship with counter-parties rather than on contract.<sup>31</sup> For an efficient economy this is not the most desirable outcome. Holistic secured transaction law reform must, therefore, take into account the institutional context in which the new law will function. Adequate training and institutional capacity building of the legal profession and other personnel who will administer the law must at the minimum accompany law reform. A more systemic approach should look at the incentive systems in various part of a reformed secured transactions system and examine whether they are adequate to ensure proper compliance with the law. This will be more demanding and difficult. These difficulties should not mean that secured transactions law reforms should not begin until all these other factors are addressed but merely that the need to address the wider institutional and systemic issues at some stage of the reform process must be recognized.

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<sup>30</sup> Paragraph 77 of *A Review of the Law and Development Activities of the ADB* (IN. 42-98).

<sup>31</sup> Rick Messick, "Judicial Reform and Economic Development: A survey of the Issues", *World Bank Research Observer*, Vol. 14, No. 1, (February 1999). Messick cites a number of surveys in Latin America that support the Hobbesian proposition that in the absence of a reliable judicial system traders would be reluctant to enter into wealth maximizing transactions for fear that the bargain would not be kept. A study in Pakistan also underlines the importance of reputation and previous dealings among subcontractors in an industrial city: Andrabi et al, *Industrial Subcontracting in the Pakistan Tractor Industry* (unpublished: 1998) and Khalid Nadvi, *Shifting Ties: Social Networks and Surgical Instrument Industry in Sialkot, Pakistan* (1999).

## EXECUTIVE SUMMARY

### Secured Transactions Law Reform in Asia: Unleashing the Potential of Collateral

1. This report is based on the work undertaken under the ADB financed regional technical assistance (RETA) No. 5773 on secured transactions law reform. It examines the way law for secured transactions affects the use by creditors and debtors of movable property as collateral in five Asian countries: the People's Republic of China (PRC), India, Indonesia, Pakistan, and Thailand (hereinafter called "RETA countries").<sup>1</sup>
2. The report presents the topic, secured transactions, the parties to the transactions, and data about movables as collateral, which Asian countries greatly under-utilize. The report explains the importance to modernizing economies of collateral and movable property, which is property other than land and buildings. After presenting the major issues to be decided concerning a secured transactions regime, the report offers a baseline policy model to evaluate the economic consequences of each component of the existing legal regime in each of the RETA countries, and important qualifications to the baseline policy model.
3. The main body of the report analyzes the law of the five RETA countries. It presents the findings from interviews with financial firms and enterprises in each country about the extent to which they use debt secured by movable property and the role law plays in their actions. The report found many problems in the legal regimes for credit secured by movable property, and remarkably little credit secured in that manner.
4. The end of the report proposes action to strengthen the regimes governing secured transactions to help Asian countries' financial systems increase credit maturities and volumes while reducing credit risk and cost.
5. The paragraphs below set out the logic of the analysis that runs through the report.

#### **Private Creditors Depend on Collateral**

6. Private creditors in all countries—common law and civil law, industrial and transitional, north and south—worry about getting their loans repaid. Everywhere, when the debtor can offer them collateral for a loan, private creditors offer larger loans, at lower interest rates, payable over longer periods of time. Compared to a debtor who cannot offer good collateral, one with such collateral can anticipate receiving six to eight times more credit, taking two to ten times longer for repayment, and paying interest rates 30 percent to 50 percent lower. Collateral is important.

#### **Producers and Merchants Depend on Movable Property**

7. In the industrial countries, modern industry and commerce require movable property as capital. Examples include equipment, inventories, computers, livestock, and fertilizer. In the United States, movable capital accounts for 67 percent of the industrial capital stock and 75 percent of gross business investment. It has about the same share of agricultural investment. Movable property is even more important for most nonfarm small enterprises. They may use \$10 to \$20 in

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<sup>1</sup> Prepared for ADB by Nuria de la Pena and Heywood Fleisig, Center for the Economic Analysis of Law, and Philip A. Wellons, Program on International Financial Systems, Harvard Law School.

movable capital for each \$1 in real estate. While few comparable statistics exist for the five Asian countries, casual observation, economic logic, and the enterprise interviews for this study suggest a similar relative weight of movable to immovable property.

### **The Problem is That Under Existing Law, Producers and Merchants Cannot Use Their Movable Property as Collateral for Credit from Private Creditors**

8. The importance of collateral to creditors and of the use of movable property to producers and merchants (who are potential debtors) implies a major problem for debtors. When, as in these Asian countries, debtors cannot use this collateral, those same debtors in their roles as producers and merchants will get little access to private credit. Although over 75 percent of their investment may buy movables, they find banks unwilling to finance those purchases. They find dealers unwilling to sell them the goods on credit. Indeed, dealers that might be willing to sell on credit without collateral may have to limit that credit. The dealers themselves cannot use their own unsecured accounts receivable as collateral to refinance from banks and other creditors. As debtors, therefore, rural and urban producers and merchants in these five countries face financing problems unknown to their counterparts in countries where movable property can readily serve as collateral.

9. The prevalence of poverty magnifies these problems in the five countries. The poor have no real estate or have only imperfect title to small parcels of land. Movable property may, therefore, be the only property the poor can demonstrate that they own. Movable property matters for everyone and for the poor, its relative weight is even greater. Micro-credit is constrained by the inability of microcredit providers to use accounts receivable as collateral, for example.

### **This Problem is Rooted in the Law**

10. This report presents detailed economic analyses, for each of the five countries, of the law of secured transactions. It tests the findings with extensive interviews of enterprises. Everywhere the finding was the same. The laws and legal processes largely prevent debtors from using movable property as collateral that is acceptable to private creditors. The legal regime for creating security with movable property is costly, complex, lengthy, and uncertain. Problems arise at each stage from creation to enforcement, in some cases in all countries and in others a subset of countries.

#### **Creation**

11. The legal provisions for creating security interests in the RETA countries do not contemplate many important types of property, transactors, or transactions. Most gaps lack a public policy justification. Even where the law contemplates a transaction, the procedure is so complex that only the most expensive collateral and the largest loans can bear the cost. Facing high risks and costs, and uncertain if the law supports their loan or contracts to buy on credit, would-be debtors find that creditors and sellers on credit often refuse to finance important transactions that their industrial country counterparts would readily finance.

#### **Priority**

12. Where the law does not set a predictable rule of priority for creditors' claims against collateral, debtors find that creditors will not take, or rely on, the collateral they offer. The prospect of unlimited subsequent security interests in collateral, all with the same priority, would make worthless the stake of any individual creditor in that collateral.

13. None of the legal regimes of the five countries sets out a predictable priority rule. This failure arises partly from many inconsistencies in the fragmented regime for secured credit. It also arises partly from conflicts with other laws that create special classes of claims, such as unpaid wages, taxes, the needs of troubled firms, bankruptcy proceedings, and other unsecured claims. These claims have a priority superior to secured interests previously registered. These laws may have legitimate public policy goals, but other means may achieve the goals better, less expensively, and more fairly, without undermining the system of secured credit.

### **Publicity**

14. Establishing priority can only support borrowers in their search for credit if potential creditors can discover the existence of prior claims against the collateral that the debtors offers. In the best systems in the world, third parties can search the filing archive over the Internet free and file in a few minutes at the cost of a few dollars. None of the five countries had a filing archive remotely approaching this standard. Their systems offered worse service that cost more.

### **Enforcement**

15. Finally, for a debtor's collateral to have value to a creditor on default, the creditor needs a way to seize and sell it that preserves its value. The process must be cheap and fast. In the five countries, secured creditors take months or even years to repossess and sell collateral. This long time far exceeds the economic life of most movable property. The result is that debtors offering movable property as collateral get no better terms than those who offer none.

## **A Problem with Extensive Economic Consequences**

### **Less Bank Credit for Micro Enterprises and the Poor**

16. Poverty is prevalent in many Asian countries. All citizens, rich and poor, creditor and borrower, pay a huge price in lost opportunities from the inability to use movable property as collateral. The relative burden on operators of small farms and businesses, and on the poor generally is severe. Large and rich producers can partly circumvent some of the problems. They may use land as security or show that they own unencumbered real estate that the creditor could lien in the event of non-payment. They may get a personal guaranty of the loan or the co-signature of a person who owns real estate. Operators of small farms and businesses, and the poor generally, rarely have land or access to guarantors. Instead of being able to offer their movable property as collateral, as they could do in countries where collateral can be used, they get no better terms than those with no collateral at all.

### **Less Non-bank Credit for Micro Enterprises and the Poor**

17. The problems also restrict credit offered outside banks. Operators of small farms and businesses face restrictions on unsecured credit. Dealers and suppliers represent an important potential source of credit to these enterprises. Dealers and suppliers know their clients well. They frequently interact with clients outside of the creditor relationship. They can often extend unsecured credit much more safely than banks, especially credit to small enterprises and the poor who have limited means of publicizing their reputations for repayment. The ability of dealers to extend credit is hampered because, in the face of legal limitations, they cannot use their own portfolios of accounts receivable as collateral for credit to refinance their own operations.

## **A More Fragile Financial Structure**

18. Two of the problems that contributed to the Asian financial crisis have received wide attention. One of the difficulties is collecting debt, while the other is the vulnerability of the economy to banking problems. The regime for secured transactions bears on each.

19. First, a good collateral system permits banks many methods of risk management. About 70 percent of bank loans in the United States are secured, and all that collateral has substantial economic value to creditors. Estimates for the five RETA countries are uncertain, but no one has suggested a number close to this. As this paper demonstrates, movable property taken as collateral has limited value to creditors if the borrower defaults.

20. Second, a major aspect of the Asian financial crisis has been asset inflation. Continued credit secured by real estate drives up real estate prices, justifying larger loans and driving up real estate prices further. When the bubble bursts and real estate values fall, banks are left with non-performing loans and eroded capital, forcing financial contraction and insolvency. A good regime for secured transactions mitigates this problem. It permits banks to take as collateral internationally traded merchandise whose price is set on the world market in a way that would be nearly impossible for credit expansion in any of the five RETA countries to affect.

21. Finally, a good framework for secured transactions reduces systemic risk. Financial institutions that can use the secured credit regime to securitize accounts receivable and chattel paper can develop lending and credit delivery systems that are independent of deposit based banking. Dependence on deposit-based banking justifies most bank supervision and regulation, as well as different forms of deposit insurance. A substantial credit delivery system that is independent of deposit based banking reduces exposure of the economy to errors in bank supervision and regulation. For countries with effective legal regimes for secured transactions, the share of banks in total credit can be as low as 40 percent credit. For other systems, the share typically amounts to much more.

## **An Economic Problem with a Legal Solution**

22. Limited access to credit has been recognized everywhere as constraining growth and aggravating poverty. Each of the five RETA countries has struggled with this problem without remedying its underlying legal roots. Rather, they have tried mitigating the effects of the problem with directed credits, state guarantees, state-funded guarantee funds, and loans by state agencies. Most of these attempts have not succeeded in substantially alleviating the constraint on access to credit for small and poor borrowers. Government-owned creditors can make loans that the private sector won't make; however, they are no more able to collect them. No one has devised a feasible and effective economic remedy to this legal problem. Success requires that public policy address this problem at its legal roots. The report gives a baseline against which to measure the law and reforms to it, as well as alternate perspectives on some of the baseline standards.

## **Next Steps**

### **Analyze and Reform**

23. A country like the five countries studied requires a detailed diagnosis of its laws governing relations between its debtors and creditors. These laws include secured credit, bankruptcy, hybrid security interests, and other laws that affect enforcement and priority. This diagnosis should set out

the adverse economic impact of each problem in the law and it should present economically effective options for addressing those legal problems.

24. New secured transactions laws should resolve each diagnosed problem. Commentaries on the law, and related laws, should set out the economic logic of each key element in the law, relating these provisions to other broad public policy issues. These economic and policy motives will help legislators and government officials to understand the reasons for proposing departures from traditional usage and guide them in making future modifications of the law that do not destroy the underlying logic of the system.

### **Reform the Filing Archive**

25. The new law will make key legal determinations that will strongly affect the technical design of the archive. Therefore, registry reform cannot effectively precede the law. However, as the filing archive occupies a central role in the operation of the law, the archive reform should begin as soon as settlement of the key features of the law takes place.

### **Train and Publicize**

26. The key features of the new law and the implications for financing should receive the widest possible publicity as well as training of judges, lawyers, and business operators in the new techniques. Policy makers may wish to consider Internet-based public awareness and training programs, given the large populations and geographic expanse of the five countries studied.