

III. THE IMPORTANCE OF SECURED CREDIT

21. Central tenets of this report are that collateral provides important benefits to debtors and creditors, and that movable property has great potential to serve as collateral because it is economically important now in many countries and will continue to become even more important to businesses in the future. As a result, strengthening the framework for secured transactions will generate economic gains for a country and reduce the risk of the financial system by broadening its structure. This chapter gives the rationale for these guiding principles.

A. Collateral Matters to Debtors and Creditors

22. Private creditors in the five RETA countries share a problem with their counterparts in all other countries. How do they know that debtors will repay their debts? Private debtors in the five RETA countries face a complementary problem. How can they persuade private creditors that they will repay their debts? Collateral helps resolve this problem, as described below. This function of collateral counters the argument one sometimes hears that collateral allows creditors to forego essential credit analysis. Collateral is not a substitute for credit analysis. It is a solution to the limits of credit analysis.

(i) Unique Characteristics of the Market for Credit

23. The market for debt presents different problems from those of other markets because rather than a simple exchange that takes place at a single point in time, some time after credit is given the debtor is supposed to repay the creditor. Of key importance are the following characteristics:

- Participants in debt markets have asymmetric information. The debtor knows its own true condition and what it will do with its debts. The creditor, with less information, must guess whether the debtor is as creditworthy as it appears at the time of the credit. The creditor must also guess about whether the debtor will really use the funds as promised. A debtor who plans to abscond with the funds will not announce this to the creditor during the negotiations.
- Creditors face moral hazard. They may believe they could trust the debtor with a small debt, but may fear that the debtor might behave differently with larger debt. The small debt, if defaulted on, cannot harm the creditor. A creditor can attempt to force the debtor to repay and absorb any loss. A default on a large loan, however, could harm the creditor, even bankrupting it. This threat puts the creditor into a straight-jacket if default looms. Rather than force repayment, the creditor may feel obliged to advance even more to the debtor to keep it afloat.
- Creditors face adverse selection. They cannot perfectly compensate for greater risk by charging higher interest rates because a debtor who agrees to pay higher interest rates might be concealing the undertaking of a very risky venture or, even worse, might have no intention of repaying either interest or principal. These considerations prompt the creditor to limit credit to the debtor, a form of credit rationing.

24. The consequences are serious. Debtors face difficulty convincing creditors that they will repay a debt. Creditors have difficulty knowing whether the debtor will repay. Debtors, however, find that they cannot get access to more credit simply by offering creditors higher interest rates to adjust

for risk. Rather, the creditor must adjust for this risk by taking steps familiar to most debtors in the five RETA countries: by making small credits at high interest rates for short periods of time to people they know well.¹ Otherwise, credit is not given.

(ii) Collateral Helps to Address These Characteristics

25. Collateral permits debtors and creditors to address the characteristics of the debt market discussed above.

26. When the debtor offers collateral, the creditor can readily assess the value of the collateral relative to the loan. The creditor has less concern about having an absolutely accurate account of what the debtor plans to do with the funds. In this way, collateral substitutes for information about the debtor and mitigates the problem of asymmetric information.

27. As the debt grows, the creditor can require more collateral, but not more honesty. In this way, collateral addresses the problem of moral hazard.

28. The creditor can adjust the size of the debt relative to the value of the collateral. By reducing the ratio, the creditor compensates for suspicions of excessive risk-taking or dishonesty. By increasing the ratio, the creditor favors a client with excellent projects bearing a high return. In this way, collateral addresses the problem of adverse selection.

29. Consequently, when the law lets debtors offer collateral effectively, a more efficient debt market results. Where private debtors can offer collateral for their debts, they will obtain larger credits, for longer periods of time, and at lower interest rates.

(iii) The Power of Collateral in Credit Markets when the Law Lets It Work

30. A simple example shows how, in practice, collateral could matter to debtors in the five RETA countries if they had a legal system that permitted collateral to do its job. The legal regime for secured transactions in the United States, which governs lending by credit unions, including those of multilateral institutions allows effective use of collateral for credit.

31. In Washington, DC, the credit unions of the World Bank, the International Monetary Fund, and the Federal Reserve, offer debtors different loans at different terms depending on the collateral they offer. These creditors would offer a debtor without collateral a loan with an interest rate of about 12.5 percent, repayable in about 33 months, amounting to as much as 50 percent of the debtor's income (Table III-1).² For a debtor offering movable property as collateral, these creditors would offer lower interest rates, longer repayment periods, and larger loans relative to the debtor's income. For a debtor offering real estate as collateral, interest rates would drop even more, while repayment terms became longer and loans even larger relative to the debtor's income. Broadly, the more and better the collateral, the lower the interest rate, the longer the time for repayment, and the larger the loan relative to income.

¹ These characteristics are not criticisms of unsecured debts. Such debts have an important place in both traditional and modern financial markets. Modern financial systems provide for complex links between unsecured and secured credit. However, unsecured debts cannot, by themselves, provide a complete basis for a modern financial system. Nor can they, by themselves, achieve other key policy objectives of expanding access to credit to the poor, and to operators of small farms and rural businesses.

² Federal Reserve terms are more stringent. Debtors are permitted a maximum of \$10,000 in unsecured credit line irrespective of their incomes.

Table III-1. World Bank, IMF, Federal Reserve Credit Union Loan Terms with Different Collateral			
(Loan terms of Credit Unions at these Institutions)			
	Interest Rate	Term in Months	Debt/ Income
No collateral: Personal loan	12.50%	33	50%
Movable Property: New Car	6.75%	60	144%
Used Car, Boat, RV	9.00%	48	113%
Immovable Property:			
Home equity loan-5 yr.	7.5%	60	142%
Home equity loan-7 yr.	8.0%	84	182%
Home equity loan-10 yr.	5.75%	120	261%
Home equity loan-15 yr.	6.25%	180	334%
Home equity loan-30 yr.	7.0%	360	434%
Source: Publicly distributed lending terms from these institutions. Debt/Income ratios derived from telephone inquiries concerning acceptable debt service/income ratios, typically ranging from 35% to 50%. The Federal Reserve sets a maximum of \$10,000 on its standard unsecured credit line.			

32. We can express these numbers more precisely, using the unsecured debt as a basis for comparison. Using interest rates, terms of repayment, and debt shown in Table III-1, we can set each value for unsecured debt at 100 and use it as the “base.” We can then express other values from Table III-1 relative to unsecured debt. Restating the results from Table 1 this way, Table III-2 indicates that when debtors offer better collateral to creditors, they pay interest rates as much as 50 percent lower, have as much as 11 times more months for repayment, and receive credit as much as 9 times greater relative to income.

33. These terms, of course, are not offered only by the credit unions of official agencies to their members. Similar terms are offered by any commercial bank in the US. Whoever the debtor, that debtor will get better access to credit when offering movable property as collateral than when offering no collateral.

Table III-2. World Bank, IMF, Federal Reserve Credit Union Loan Terms with Different Collateral Relative to Unsecured Loans			
(Loan terms of Credit Unions at these Institutions)			
	Interest Rate	Term in Months	Debt/ Income
No collateral: Personal loan	100%	100%	100%
Movable Property: New Car	54%	182%	289%
Used Car, boat, RV	72%	145%	227%

Table III-2. World Bank, IMF, Federal Reserve Credit Union Loan Terms with Different Collateral Relative to Unsecured Loans			
<i>Immovable Property</i>			
Home equity loan-5 yr.	60%	182%	283%
Home equity loan-7 yr.		255%	364%
Home equity loan-10 yr.	46%	364%	521%
Home equity loan-15 yr.	50%	545%	669%
Home equity loan-30 yr.	56%	1091%	869%

Source: Derived from data in Table 1.

(iv) The Limited Power of Collateral in Asia

34. The five RETA countries provided no examples showing the breadth and power of collateral to compare with those from economies where the secured transactions regime functions more effectively.³ However, the Enterprise Interviews revealed limited areas where institutions governing collateral in Asia worked relatively well, even in the face of a severely limited legal framework. These examples show that the difficulties facing Asian financial sectors do not arise from deep and complex cultural, economic or social roots. They emerge from laws that no longer match modern financial realities, laws that could easily be changed. These examples display the emerging power of collateral in Asia.

(a) Thailand, Indonesia: Selling Cars with Retention of Title

35. In both Thailand and Indonesia, selling cars with a device called "retention of title" is a well-established and profitable business. Combining the characteristics of cars with the characteristics of retention of title provides a "micro-secured transactions reform." The system of title registration for cars substitutes roughly for a genuine filing archive for security interests. The fact that the car operates on the public way where the "owner-creditor" can readily find it substitutes roughly for private repossession. The fact that the police will "cooperate" in finding a "stolen car" provides an enforcement system. The fact that the creditor retains title permits the quick resale of the repossessed vehicle.

36. The problem with this as a solution is that it will not work for much more than cars. As one sees in the next section, cars are only a small part of the capital stock. For other capital, there is no title registry. The equipment is not kept in the public right of way, so it cannot be repossessed so fast. It is a serious breach of law for the police to cooperate in entering the premises where the equipment is kept.

37. The Enterprise Interviews revealed that Asian creditors understand this perfectly. The result for Asian debtors is that the same business operator who could buy a car on credit cannot buy a forklift truck or a lathe on credit. The same farmer who could buy a truck on credit cannot buy a tractor or a pump on credit. Such bizarre distinctions among pieces of equipment, of course, have no rationale in public policy. Rather, they arise from antiquated laws that no longer serve Asia's economic needs.

³ See Heywood Fleisig, "The Power of Collateral", *Private Sector*, (March 1995) and Heywood Fleisig, "Secured Transactions: The Power of Collateral", *Finance and Development* (June 1996).

38. If the system works for cars, it can be adapted to everything else. The fact that it does work for cars in Asia just as well as it does in reformed economies supports the view that the problem lies in the laws of the five RETA countries and nowhere else.

(b) India, Pakistan: Financing Inventory

39. For all modern economic enterprises, financing inventory is crucial. Inventory is, on average, a substantial part of total capital. For small operations, though, particularly those in manufacturing and trade, inventory may represent the operator's entire stock of capital. Credit to finance inventories is commonplace in many countries—a lucrative business for banks and a key source of working capital for small enterprises.

40. In Thailand, Indonesia, and PRC, however, no bank will make a loan secured by that inventory. More serious for the typical small enterprise, those dealers selling on credit to the small enterprise also cannot get loans secured by their inventory. That raises the cost of funds to the dealers, reduces competition among dealers and, for the small enterprise, raises input and financing costs that they face.

41. Inventories are unacceptable as collateral in these countries because their laws require the specific identification of the item used as collateral.⁴ However, the very nature of inventory often requires that it change its composition constantly.

42. Asian creditors understand this well. As one Indonesian banker put it in patient response to an Enterprise Interview question, "it is hard to specifically identify something that changes all the time."⁵ As a result, debtors in those countries get no credit secured by inventory. They get worse terms on credit sales from dealers who might be able to finance more if they could refinance their unsecured selling operations.

43. Nearby in India and Pakistan, however, banks and finance companies make loans secured by inventories all the time. They can do this because the laws of India and Pakistan do permit taking a security interest in a generally described inventory whose composition changes all the time. This is not such a bright a spot as it might seem because the laws of India and Pakistan also restrict this loan to corporations—disqualifying, at a stroke, all small farmers and micro-enterprises.

44. It is hard to even imagine that anything besides this difference in the law can explain this difference in creditor behavior. The different behavior has nothing to do with culture, business acumen, general training, or the macro-economy. The Enterprise Interviews indicate clearly that where the law permits a creditor to take inventory safely as collateral, creditors will do so. The Enterprise Interviews clearly indicate that this is exactly the reason that creditors give for not taking such inventory. The inventory of the average Thai or PRC merchant cannot differ enough, on average, from the inventory of the average Indian or Pakistani merchant to explain why no bank in Thailand or PRC will accept inventory and most banks in Pakistan and India countries will. One cannot explain the different behavior of creditors other than with the law. The inventory of the average Indian or Pakistani unincorporated business must overlap in quality and value with the inventory of some incorporated businesses. Only the difference in legal standing can explain why banks commonly secure loans with inventory to the first group and never with the second.

⁴ Discussed in detail in later chapters.

⁵ Indonesia Enterprise Interviews.

45. These examples and practices show that the operation of a more effective secured transactions regime is readily within the grasp of the five RETA countries and already in operation in isolated examples. They illustrate the potential power of collateral in credit markets beyond simple bank lending. They do not, by themselves, comprise a legal reform sufficient to support the financial system that Asia needs to grow, provide broad access to credit, and stabilize its financial sectors. The balance of this report discusses the full range of legal problems and their economic impact.

B. Movable Property Plays a Major and Growing Role in the Economy

46. The second tenet is that movable property is essential for production. It is beyond the scope of this report to document the degree of importance, but data from an industrial country provides a clear idea of how movable property will grow in importance in the five RETA countries as they continue to modernize.

47. The stock of privately-owned, non-residential movable capital is about \$3,000 billion dollars in the United States. This represents about forty percent of the industrial and commercial capital stock of the United States and about twenty percent of its entire capital stock (Table III-3). Though the table does not prove this, obviously few producers would build factories with no equipment. Few developers would erect modern office buildings with no elevators, furnaces, or air conditioners. Fixed and movable property, therefore, typically complement each other in the capital stock. A producer who cannot invest in movable capital will not invest in fixed capital either.

Table III-3. Size and Composition of a Modern Capital Stock: Example of the United States			
	\$ Billions	Shares of Total	
<i>Total GDP:</i>	\$ 7,265		
Private Capital Stock	\$15,686		100%
Residential	\$ 7,733		49%
Non-Residential	\$ 7,953	100%	51%
Fixed	\$ 4,903	62%	31%
Movable	\$ 3,050	38%	19%
Capital/Output Ratio: 2/2			

Source: US Capital stock taken from "Improved Estimates of Fixed Reproducible Tangible Wealth, 1929-95", by Arnold J. Katz and Shelby W. Herman (Survey of Current Business, May 1997, pp. 69-92)

48. This movable property is divided in importance broadly among general industrial equipment, computers, transport equipment, and other equipment, as indicated in Table III-4. Of course, the different types of property vary in the extent to which they can usefully serve as collateral, for reasons discussed later in this report.

Type of Equipment	Share of Total	
Industrial Equipment	34%	
Information Processing and related equipment	25%	
Transportation and related equipment	21%	
(Of which, Aircraft)		4%
Other Equipment	20%	
Total	100%	

Source: See previous table.

49. While comparable data are not available for the five RETA countries under review, broad data indicate that sectors intensive in movable capital—services and manufacturing—are large and rapidly growing sectors there (Table III-5). These sectors, much more intensive in movable capital than the average industry, represent more than half of the value added in GDP in each country and, typically, their most rapidly growing sectors.

50. The Enterprise Interviews, set out below, confirm this broad quantitative importance of movable property in these areas. These interviews covered a broad range of dealers in equipment, fixtures, appliances and computers, agricultural inputs and light manufacturing. As would be expected, these dealers were preoccupied with managing their movable property.

	Manufactures	Services
	1998	1998
People's Republic of China	37%	33%
India	19%	45%
Indonesia	26%	41%
Pakistan	17%	50%
Thailand	29%	49%

Source: Selected World Development Indicators, 1999.

51. Movable property is already an important part of the productive economy in the five RETA countries. Its role will continue to grow. Debtors should be able to use the full range of movable property as collateral for credit.

C. Improving the Framework for Secured Transactions Generates Economic Gains

52. While later chapters document specific ways to strengthen the regime for secured transactions, one may ask if doing so would be useful. The answer is that qualitative changes could have a significant effect, producing several important economic changes in the allocation of resources and the distribution of income.

(i) Effects on the Chain of Credit

53. A strengthened regime for secured transactions will allow the financial system to allocate capital and savings more efficiently, lower interest rates, lengthen maturities, and increase credit volumes. It will permit more investment and capital per worker. The following paragraphs explain these points.

(a) Allocates Capital More Efficiently

54. Farms and businesses in North America often obtain similar interest rates for credit for movable property and real estate. Interest rates on debt secured with a fungible, high quality, homogenous, traded commodity—such as wheat, cotton, cattle, or inventories of current computer programs—would pay interest rates a bit below the home mortgage rate. Debt secured by cars would run a bit higher. Debt secured by more specialized equipment or less readily saleable or more perishable commodities might pay somewhat more than the home mortgage rate.

55. Businesses in the five RETA countries, however, face much higher interest rates for movable property. That leads farm and business operators in unreformed systems to reduce the amount of movable property that they use relative to real estate in the course of doing their business.

56. These problems with secured transactions affect not only the volume and price of investment, but also its allocation. For operators of farms and businesses who do not own their land or buildings, a credit system linked rigidly to real estate limits development. As a business expands, for example, its sales will increase. This higher volume of business may or may not require more physical space, but will certainly require larger inventories. If inventory cannot serve as collateral and the business has already borrowed the maximum against its real estate, the business must finance this additional inventory out of its own capital. However, the same business could borrow, for the purpose of expanding the size of its physical plant because creditors would take that expanded real property as collateral. This interest rate structure that results from a weak legal framework for secured credit diverts investment away from inventory and equipment and toward physical plant. Consequently, facing the same physical production processes, producers in the five RETA countries studied will get less increase in output from the same total investment. Physical plant may be less economically valuable than additional inventory. In agriculture, increasing farm profits typically increases yields per acre by using more machines, plant protection agents, fertilizer or livestock on a given amount of land. The overall amount of arable land has not changed appreciably in years. New capital formation in agriculture typically requires investment in machines or livestock increases relative to investment in land. However, when machines and livestock cannot serve as collateral and creditors will extend credit only for more land, farmers have incentives for investing more in land and fixed assets than in potentially more productive livestock and machinery.

57. This behavior, of course, is economically efficient for the individuals facing the constraints presented by the secured transactions regime. That is, behaving this way is what the best operators of farms and business can do in the unreformed framework. However, that framework places a huge burden on the economy in terms of lost output and the foregoing of better investments.

58. Put differently, economic agents in countries with more effective regimes who have the same total capital will produce more output than producers in the five RETA countries, because fixed capital and labor combine with more movable property there. Productivity per worker gains when farms and businesses can profitably hold larger inventories, use movable equipment, and install fixtures. Changing the legal framework in the five RETA countries would permit an increase in output.

(b) Allocates Savings More Efficiently

59. Most individuals do not save exactly what they invest. This is natural in a free market economy. The gain from financial markets arises mainly from providing a cheap and efficient means of shifting savings from savers to investors. But savers will demand safeguards that guarantee their funds. If investing debtors cannot provide such guarantees, then the savers will not let them use their funds. Reducing the riskiness of this collateral will permit transferring more savings from savers to borrowing investors. As a consequence, total investment will rise.

60. At present, in the five RETA countries, savers will lend directly to those with good investment opportunities only when they know them personally and well. Savers will not transfer funds to others, because savers can take no collateral that will reduce their risk. Rather, savers will move funds to state insured banks or overseas to better insured banks or to countries where the legal framework does permit the use of collateral. One business or farm may have no access to credit and forego investment opportunities with double-digit returns, while a neighboring farmer or business operator exports funds to foreign banks so that he may earn single-digit interest rates.

61. In each of these examples, collateral restrictions force the businessmen and farmers into financing expansion of their growing businesses out of their own capital because these enterprises have limited access to borrowed funds. A secured transaction system that directs credit away from more rapidly growing businesses and toward slower growing businesses will not promote the most economic growth.

(c) Produces Lower Interest Rates, Larger Credit

62. This lack of usable collateral means financial markets in these countries operate ineffectively in channeling investable funds towards the socially most productive purpose.

63. Where North American producers can approach competing creditors offering debt secured by movable property at 100 to 700 basis points⁶ above the government borrowing rate, in volumes equal to two to six times their annual income, their counterparts and competitors in the five RETA countries will have no access to such credit.

(d) Permits More Investment

64. The difference in interest rates between developed and less developed secured transactions regimes can decrease if the later one refused to efficiently address these problems in secured transactions. In the United States, for example, rates of interest on loans for a wide array of equipment, cars, and other movable property run ½ to 1 percentage point above the mortgage interest rate. In the United States, debt secured exclusively by movable goods secure nearly 40 percent of the country's credit.

65. Except in countries suffering from the most severe financial stress and facing attempts at protecting overvalued exchange rates with draconian monetary policy, an efficient framework for secured transactions can make a significant contribution to reducing the cost of financing movable equipment.

⁶ One percentage point contains 100 basis points.

(ii) Effect on Policy Objectives

66. Reform will support other policy objectives, allowing more credit to the poor, small businesses, and farmers, distributing economic gains more broadly, and reducing the riskiness of the financial system.

(a) Permits More Credit for the Poor, Small Merchants, Farmers

67. Lack of access to credit affects all farmers and business operators doing business in unreformed systems. Even the wealthiest farmers and the most profitable companies in such countries could gain from innovations that permitted cheaper financing of equipment and inventories. Even landlords would gain if the tenants had more access to credit, higher production, and more capacity to pay rent.

68. However, the burden of an inadequate framework for secured transactions falls most heavily on the poor, notably the farmers who work rented land, or who sell their services and do not own land, and on small businesses and factories operating in rented premises. For them, an inadequate framework for secured transactions does not mean they get less credit. It means they get no credit at all or credit from internal sources at exorbitant luxurious rates. Other credit agencies, including NGOs that attempt making unsecured credit, will find their ability to advance credit vastly constrained because without a framework for secured credit they cannot use their portfolios of unsecured debt as collateral to raise funds for onlending.

(b) Produces a Broad Distribution of Economic Gain from Reform

69. Reform produces a broad gain shared by most members of society. Large businesses gain because they can more easily finance investments in movable property. They can purchase equipment on credit and reduce their cost of working capital by using accounts receivable and inventory as security for credit. Those without land, as noted above, gain because they may, for the first time, have access to secured credit. The reform does not diminish the value of reputation and land as collateral; rather, it adds a new class of collateral. Movable collateral reduces the risk to the creditor at no additional cost to honest debtors. Consequently, permitting the use of movable collateral produces a large net overall gain.

(c) Reduces the Riskiness of the Financial Structure

70. In most systems with weak secured credit regimes, banks account for as much as 95 percent of total credit. In the United States, they account for about 40 percent of total credit. Other financial institutions, even though they do not take deposits, can become important sources of credit when the framework for secured credit works well. These institutions can assemble the credit they give into portfolios that they can use as security to refinance their credit from capital markets, private creditors, and banks. Such a financial structure does not depend so heavily on the problems arising from deposit-based financial structure and their consequential dependence on the quality of supervision and regulation of banks. If countries reform their secured transactions systems, the share of banks in overall credit will fall.

71. At the same time, because the framework for secured transactions creates so many new credit opportunities that credit rises relative to GDP. In the United States, credit runs to about 200 percent of GDP, several times greater than most unreformed economies. As a result, banks gain too from expanding the framework of secured credit.