

equipment, one to three years may represent a substantial fraction of its economic life. For a flour mill and bakery enterprise, some goods, such as bread, depreciate very fast. Others may last longer, such as packed dry foodstuff. Different enterprises provide endless examples; most enterprises have property with a broad range of economic lives.

355. Slow and costly enforcement imposes a high price expressed in loss of access to credit. A period of collection and sale of one to three years makes most movable property useless as collateral.

356. For certain types of collateral, notably accounts receivable, opportunities exist to set common rules governing secured creditors and obligors. With the rights of obligors clear and fair, secured creditors should be able to approach them independently of the courts.

357. A lengthy stay on secured creditor rights during corporate reorganization may reduce the value and affect the use of property with a short economic life. One solution, to abolish the stays, would run counter to trends in reorganization around the world that rely on binding secured creditors at least temporarily and may not address other policy considerations.<sup>532</sup> Other solutions are to shorten the stays and making them discretionary rather than automatic in legal systems where the courts will not abuse their discretion. If reorganization affects a small fraction of the movable property, as it does in the United States, this may not appear as a substantial problem to potential creditors. Ironically, it may also not appear serious in a country like Thailand, where defects in creation mean that collateral is mostly tangible/fixed capital and not raw materials/inventory or other such movables.

## **IX. HOW PROBLEMS IN SECURING TRANSACTIONS WITH MOVABLE PROPERTY HURT CREDITORS AND DEBTORS**

### **A. The Enterprise Interviews**

358. Structured interviews with creditors and debtors confirmed the very limited role that movable property plays as collateral for debt and the low levels of access to credit by key groups, compared to what one would expect. This section presents the methodology, explains its focus on creditors as a way to understand debt, and summarizes the findings.<sup>533</sup>

#### **(i) The methodology**

359. The previous chapters set out an economic analysis of the law. They examined how the legal framework for secured transactions in the five RETA countries would affect the incentive of creditors to make advances. The supply of credit would affect the debtors' likely access to credit when they possessed different types of collateral. Based on these legal findings, the study developed hypotheses about how different creditors would behave. Teams in each of the five RETA countries interviewed financial firms and other enterprises, such as dealers, who operate as both creditors (they sell on credit) and debtors (to fund their business). The interviewers asked structured questions designed to learn how creditors give credit to debtors with different types of collateral. Some interviewees confirmed that debtors' accounts of loan contracts were broadly consistent with the accounts of creditors.

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<sup>532</sup> "The Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms", *Law and Policy Reform at the ADB, Vol. 1, 2000 edition*.

<sup>533</sup> This chapter is based on the Enterprise Interviews, separately available from the ADB.

**(ii) Focus on Creditors to Understand the Problems Facing Debtors**

360. This study differs from others because, while one of its chief motivations is to understand barriers to access to credit, it does not focus on the views of debtors. Debtors know, mainly, that they do not get credit. They usually do not know why they fail to get credit. So this chapter focuses on the views of creditors, who explain to us why they do not give credit to debtors. It is this creditor-focus of these interviews that allows us to uncover the precise link between the private creditor's refusal to give credit to the debtor, the concerns that the private creditor expresses about the legal framework for collateral, and the debtor's consequential lack of access to credit.

361. In keeping with this focus, the teams in each country interviewed a broad cross section of financial firms and businesses. Dealers, traders, and manufacturers operate simultaneously as debtors and creditors. We use them as creditors to understand better how their own policies about extending credit to their clients confirm our investigation into the problems we identified earlier in the law. In financial terms, they offer suppliers' credit and we refer to them as a group in this way. We also use them, however, as debtors to corroborate the stories of the banks that finance them.

**(iii) Financial Intermediaries and Suppliers Behaved as the Legal Analysis Predicted**

362. The Enterprise Interviews of suppliers reveal that their credit and debt had the characteristics listed below. This is the behavior anticipated in the four preceding chapters by the detailed analysis of the legal regimes for secured credit. The following sections elaborate these points.

- Enterprises give relatively little credit when they sell, contrary to the practice in countries with strong systems of secured credit
- Movable property plays a minor role as collateral in the five RETA countries.
- When enterprises do give credit,
  - many give it on relationships and guarantees, rather than movable property as security;
  - much is secured by land or criminal penalties, but not by movable property in the debtor's possession;
  - if the credit is to buyers, the enterprises do so without the security of the goods that they sell or the goods that are produced from the goods they sell, so there is very limited use of suppliers' credit with purchase money security interests; and
  - when movable property serves as security, it is by hybrid security interests, not by strict security interests.
- When the same enterprises borrow, they use less than one would expect of their own movable property as security for the debt they raise.

363. The Enterprise Interviews reveal that suppliers are largely unwilling to sell equipment on credit. There are three important general exceptions. In all countries, finance companies, and some dealers, are willing to sell cars on credit. In Thailand, Indonesia and PRC, dealers sell titled equipment on credit using special laws designed for certain types of equipment. In India and

Pakistan, dealers are willing to sell other equipment on credit and finance companies and banks are willing to finance their credit.

364. Registered transport equipment amounts to less than a quarter of movable property used in production, so these regimes offer most debtors only limited access to credit. Debtors without real estate—typically all the poor—have little or no access to credit at all. The end result of this is a financial system perilously dependent on banks that give credit based on “reputation”.

365. The Enterprise Interviews reveal broadly that private banks, with some interesting exceptions discussed below, take little movable property as the sole collateral for credit. Instead, they give credit only to debtors who offer real estate as collateral, or own such property, or offer the personal guarantee of someone else who did. Interviews with dealers—agents who both give and take credit—are consistent with the discussions with banks. They confirmed that banks would only accept such collateral from them. Moreover, the Enterprise Interviews find that banks typically do not refinance dealers who extend either secured or unsecured credit, if the debt instruments offered by the dealers are the only collateral. Dealers confirm that they do not receive such credit unless they can also offer a real estate guarantee.

**(iv) Enterprise Interviews Show that Creditors will Provide Credit Where the Law Permits Efficient and Secure Credit**

366. Unlike a detective thriller, the path of evidence here is clear. Over and again, in every country, for every type creditor, for every type of transaction, large and small, the trail leads back to characteristics of the legal framework that prevent debtors and creditors from undertaking mutually beneficial transactions. The legal research tells us to look there. The Enterprise Interviews confirm that all bank and non-bank creditors and all dealers selling on credit understand and can explain how problems in the law prevent them from extending credit.

367. The credit chain (see Box II-1 in Chapter II) is under used in each of the five RETA countries because, as this chapter shows, the legal regime for secured transactions is weak. In countries with strong regimes, various instruments give the seller/creditor security interests in the personal property of the buyer. Some of these instruments can be negotiated up the credit chain from one entity to another to help secure each loan. The inability to offer certain types of security interests means that producers cannot tap funding sources needing that collateral. For example, the ability to bundle and sell obligations due to it enables a firm to securitize these assets and tap savers through money or capital markets. We find no evidence of this in the five RETA countries.

368. This chapter has three major sections. It begins with the suppliers in the middle of the credit chain—the dealers and others who both take and give credit—to understand better why they do not sell more on credit, and raise debt more against movable property. It then moves to the financial firms, to investigate the reasons they accept some collateral and not others. Finally, it links the financial behavior to the legal problems explored above.

**B. Suppliers’ Credit and Debt: Merchants, Traders, Dealers, Manufacturers**

369. In countries with a strong framework for secured transactions, merchants, dealers, traders and manufacturers provide essential credit. These non-financial creditors have several important advantages over banks in acting as direct providers of credit to consumers, businesses, and farmers. These advantages, listed below, let them play an active role as creditors that increases the availability of financial resources, improves its allocation, and reduces its cost. See Box IX-1.

370. These advantages would lead one to expect to find that merchants, dealers, traders, and manufacturers play an important role in supplying credit to those to whom they sell. In the five RETA countries in this study, however, the problems with laws governing secured transactions, described above, suggest that one might find the opposite. Credit as a percent of sales would stay relatively low. Due to the particularly weak laws governing interests in personal property, one would anticipate finding that the non-financial firms do not commonly rely on personal property as collateral for securing credit that they do make. As described above, many types of personal property cannot serve as collateral, registration does not commonly take place, the priority of a creditor's interest in the property cannot receive a guarantee, and enforcement presents many hazards.

371. With some important and interesting exceptions, the findings of this study confirm the hypothesis that the weak laws result in limited credit from enterprises and the limited use of personal property as security. Even when buyers do raise debt a substantial part of the sale price of goods, they often raise debt from third party creditors, such as banks or finance companies, rather than the enterprises selling the goods. When enterprises offer credit, they frequently do so not on the security of personal property in the debtor's possession but on the basis of relationships and personal guarantees, land and personal property in the creditor's possession, or using hybrid security instruments such as conditional sales. In cases where one would naturally expect that the goods sold serve as collateral, such as car sales in several of the countries, they do not serve that role in several of the countries. So this study leaves us with a few examples in which personal property does serve as collateral for credit rather than the many manifestations of its use as collateral that one sees in countries with stronger systems of secured credit.

372. The overall effect uncouples the credit chain in the five RETA countries studied here. The chain worked well in some of the sectors we studied. In Indonesia, dealers generally sell farm inputs with rolling credit, though the settlement date is short. They execute some form of negotiable instrument, such as a promissory note, as evidence of the transaction. The dealer can then use the note as security for generating funds for his business. The note moves up the credit chain as security. However, this activity represented the exception. In the five RETA countries, enterprises do not supply their buyers with much credit secured by personal property. In some of the sectors, it actually seems that the enterprises we studied receive more or better credit than they pass on to their buyers. The credit chain does not work well.

373. The following examples illustrate these points, drawing on material from all countries.

**(i) Enterprises Use Relatively Little Credit When They Sell**

374. In the Asian countries examined for this report, the power of collateral to affect credit, and therefore purchases and sales, is evident much more in its absence than its presence. In many situations more credit would lead to more sales, but the firm is not willing to give credit more to buyers because the risk is too great. Buyers cannot offer collateral, effectively, to reduce the risk. This emerges consistently from our field data, which come from structured interviews rather than aggregate quantitative data contrasting secured and unsecured credit.

**Box IX-1. Special Advantages of Suppliers as Creditors**

- Dealer information about debtors

Local dealers act as important suppliers of credit and potentially could have more importance. Local dealers have many non-credit dealings with local customers and local businesses. Dealers often know their clients well. That dealer can also grant small and graduated credits. For example, a dealer may sell on credit a small amount of inputs. Or, an equipment dealer might let a customer pay a few days after receiving a small part of the payment. In exchange for this small risk, the dealer gets information about the repayment practices of his customer. A large number of transactions over a long period of time, as well as extensive contacts in the locality, let the dealer know these potential debtors better than a bank could. Moreover, dealers get this information in the course of their other business dealings. As a result, this information has a much lower marginal cost for the dealer than it would have for a bank

- Debtors' incentives for paying dealers

In general, the hope for access to more credit in the future provides the main incentive for paying an unsecured loan. Dealers have, however, an additional advantage. Dealers maintain a continuing non-credit relationship that arises from the need of the customer for services, inputs, and equipment. A defaulting debtor not only loses access to future credit; the defaulting debtor may also lose access to repair services or future supplies of inputs. This puts the dealer in a good position for supervising and monitoring credit sales at a lower cost than a bank could.

- Dealers' abilities to repossess and sell.

The dealer, as a local agent, is in a good position to follow the location and disposition of the goods in which the dealer might take a security interest. For example, a seller of pesticides or fertilizer might take a security interest in the future crop of the farmer; or a seller of equipment might take a security interest in the equipment. Located in the area, with many dealings with the debtor and with other residents, they can readily monitor the collateral. When necessary that they repossess and sell, they will have familiarity with the local system of selling used equipment and can usually readily make arrangements with the local purchasers of crops for purchasing a repossessed crop.

375. The interviews show dealers that curtail their credit and insist on cash payment. Or if they give credit, the dealers insist on some form of a guarantee or a relationship that many potential debtors lack. Those who lack these personal ties cannot raise debt. Examples in Box IX-2 illustrate the relationship between credit, sales, and risk in each country.

**Box IX-2.**  
**Examples of Limited Credit from Suppliers**

- In Indonesia, a manufacturer reported that it only loaned to customers in a very selective way, based on existing relationships rather than collateral. The result, he acknowledged, was "some kind of stagnation on selling because this . . . selection directly limits [our] target market."
- In PRC, according to a computer dealer, "If we offer more credit in making sales, there should be more sales. We are not willing to offer credit because it is risky and the collection is not ensured."
- In Thailand, a dealer in farm inputs said that it could sell more by offering more credit but sees that as too risky.
- In Pakistan, a dealer in manufactured goods only offered credit to customers with which it had a long established relationship, which is a substitute for collateral. New customers had to pay cash to buy, so the dealer could not offer credit to increase its customer base. "Sales could be increased" by offering more credit, according to the dealer, but that would add to the risk.
- Indian assemblers in the gray market for computers agreed that more credit would sell more goods. Fixtures dealers said they could sell more but did not offer more credit "because of the risk of collection."

Source: Enterprise Interviews.

376. Collateral can help to solve these problems in the manner described earlier.

377. Among the Asian enterprises that we studied, many use credit less than one might expect. This affects both sides of their balance sheet, in terms of financing their operations and supporting their sales. The low use of credit suggests the need for effective collateral. First, we look at the liability side of the balance sheet. A large portion of all the Asian enterprises interviewed raise very little debt.<sup>534</sup> We asked them how important credit was as a share of all their funds. Some chose not to respond because they wanted to keep this information from rivals. Of the 59 enterprises that did respond, however, a surprisingly high number (26) said that credit to them was low, less than 30 percent of their total funding. Another 26 said credit accounted for 30 percent to less than 70 percent of their funding, a moderate amount. Only 7 said that 70 percent or more of their funds was debt, which would be high. The large portion of enterprises reporting low use of credit (under 30 percent) suggests problems in the credit systems of the five RETA countries.

378. A closer look at how the different types of enterprises raise debt suggests that collateral is not doing its job well for many debtors in the five RETA countries. We interviewed seven types of dealers, those who sell farm inputs, general merchandise, cars, heavy equipment, manufactured goods, computers, and fixtures.

379. Dealers in general merchandise relied least on credit: nine of the 16 dealers reported a low level of debt. It was moderate for five and high for only two. It appears that the dealers could raise debt more if they could use general merchandise more effectively as collateral.

<sup>534</sup> The sources for this and the following paragraphs are the Enterprise Interviews for each of the five RETA countries.

380. Two other types of dealers relied less on credit than one might expect: dealers in heavy equipment (five low, two moderate, two high) and dealers in computers (four low, three high). Both products should serve as effective collateral for credit in a system that works well, but they do not appear to have done so here.

381. Among the dealers in farm inputs, five of the 11 that we interviewed reported low use of credit (five more reported moderate use and only one high use).

382. In each of these four groups, a majority or near majority of dealers relied on credit for less than 30 percent of their funding, and many used very little or none. The only predominantly moderate users of credit were dealers in fixtures, cars, and manufactured goods.<sup>535</sup> Fixtures and cars, at least, can serve as collateral even in weak systems for secured transactions, and did so here.

383. The story is similar on the other side of the balance sheet. In these five RETA countries, suppliers' credit is low for those who buy from these dealers. If problems of risk could be managed, one would expect the credit chain to work, as sellers give credit to their buyers. Our interviews did not reveal much evidence of this beyond very short-term deferred payments. We asked the enterprises for the portion of their sales that was supported by credit they offered. Overall, buyers from 33 of the 66 enterprises that we interviewed—or fully 50 percent—received low or no credit from the sellers (here, low refers to credit that is less than 30 percent of sales). The other 33 enterprises split almost evenly, with 16 providing moderate credit (30 percent to less than 70 percent of sales) and 17 providing high credit (70 percent of sales or higher). As the following paragraphs explain, these moderate or high levels of credit are misleading.

384. In all five RETA countries, almost half the moderate or high levels of suppliers' credit was very short term, from as little as two or three days up to 90 days. Suppliers' credit was short term for seven of the 16 enterprises giving moderate credit and for nine of the 17 giving high credit. This was particularly true for dealers in fixtures (five of seven), manufactured goods (three of seven), general merchandise (four of eight), and a few dealers in farm inputs (three of 12). This kind of delayed or slightly deferred payment greases the wheels of commerce, but it does not provide the buyer with the breathing space that would allow it to use the goods productively while paying for them. The incongruity is most striking for fixtures, and perhaps also for manufactured goods.

385. Limited suppliers' credit does not mean debtors have no access to credit. The interviews revealed two types of enterprises that relied on other creditors to support their sales. Nine of the 11 car dealers provided no credit to buyers but relied on finance companies, and secondarily on banks, to give credit to car buyers. It was clear that most of these third party creditors took a security interest in the cars. Of the 11 dealers in heavy equipment, seven provided only low credit but four of these relied on finance companies and banks to fund the buyers' purchases. Among the other five types of enterprises, however, no significant number of firms revealed that their sales relied on third party creditors to fund the buyer, despite the limited suppliers' credit.

386. In sum, the picture that emerges from the interviews of dealers in the five RETA countries is one of very constrained credit. The enterprises often report limited credit measured either by volume (credit as a portion of sales) or by maturity (much is very short term). If one nets out the types of enterprises that explicitly rely on third party finance (car and heavy equipment dealers) and eliminates those others that only supply short term credit to their buyers, the picture is bleak. Only eight enterprises of the 66 give credit at a high portion of sales, another nine do so for a moderate

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<sup>535</sup>Dealers in fixtures (2 low, 3 moderate), dealers in cars (1 low, 3 moderate, 1 high), dealers in manufactured goods (0 low, 5 moderate, 1 high). See Enterprise Interviews for all five RETA countries.

portion, and 18 do so only for a low portion. The credit chain does not seem to be working well in these Asian countries. As earlier chapters show, the legal system does not let debtors provide the kind of collateral that would sufficiently reduce the creditors' risks, in the manner described above, to induce them to offer more credit.

387. This sketch of the limited use of credit and collateral suggests that the relationship between them in the five RETA countries is not healthy. Better collateral could permit greater use of credit by the enterprises. The next section describes the limited role of collateral, particularly movable property, in the five RETA countries.

**(ii) Movable Property Plays a Minor Role as Collateral in the Five RETA countries**

388. Many of the enterprises that we interviewed relied on movable property as collateral much less than one might expect to raise funds from creditors. See Box IX-3.

389. The examples in these Boxes illustrate several patterns that we observed in the way debtors and creditors in the five RETA countries reduce credit risk without relying on movables as security. The following paragraphs describe these patterns.

**(iii) Many of the Enterprises Give Credit on Relationships and Guarantees, Not Movable Property as Security**

390. In several sectors the credit, which may be substantial or limited, is given to trusted customers or on the basis of bank or personal guarantees rather than secured with movable property. This is the case among wholesalers of general merchandise in PRC, India, Indonesia, Pakistan, and Thailand.<sup>536</sup> Indeed, in the latter two countries wholesalers do not take any security for their credit. In PRC, the heavy equipment dealer and the fixture dealer, who would give credit long-term, required a guarantee.<sup>537</sup> In Indonesia, relationships and guarantees dominated credit by dealers in computers, farm inputs, and heavy equipment. Many respondents only depend on traditional business principles that highly value trust among business actors. The more trust that the debtor has from the creditor, the bigger the loan facility to the debtor. The bank guarantee can be automatically executed if the debtor defaults. The debtor has to sign a power of attorney that gives the creditor the power to withdraw the money in the bank guarantee in the event the debtor default. When banks provide guarantees, they only accept cash or land as collateral, not movable property.<sup>538</sup>

**(iv) Many Enterprises Give Credit Secured by Land, Movable Property that They Possess as Creditors, or Criminal Penalties, But Not by Movable Property in the Debtor's Possession**

391. It is a commonplace in many countries that creditors require as collateral land or movable property in their possession and will not accept movable property in the buyer's possession because the law does not protect them. In this study, dealers in manufactured goods consistently refused to accept movable property in the debtor's possession as collateral and either required land (India<sup>539</sup> and PRC<sup>540</sup>), pledged securities such as deposit certificates (Indonesia and PRC<sup>541</sup>) and

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<sup>536</sup> All Enterprise Interviews.

<sup>537</sup> PRC Enterprise Interviews.

<sup>538</sup> Indonesia Enterprise Interviews.

<sup>539</sup> India Enterprise Interviews.

<sup>540</sup> PRC Enterprise Interviews.

<sup>541</sup> PRC and Indonesia Enterprise Interviews.

**Box IX-3. The Limited Role of Movable Property as Collateral**

- A farm input dealer in Indonesia never asks for collateral because it chooses to resolve collection problems through negotiation and never through the legal authorities, despite the financial crisis of the last several years.
- In India, a general merchandise wholesaler gives credit only to trusted customers, from whom it requires no collateral, or to large new customers who provide personal guarantees. It does not give credit to individuals or companies that buy only small amounts because it would "need to check credentials" and does not want "the additional headache of having to enforce claims."
- A Thai auto dealer loaned medium-term but did not take a security interest in the cars, choosing instead to retain ownership until payment was complete. This may facilitate enforcement by the creditor but restricts the debtor's ability to borrow further against, and dispose of, the car.
- An Indonesian dealer in heavy equipment "prefers to settle all transactions in cash" but when it gives credit the loan is secured by personal and corporate guarantees from the debtor and the creditor retains ownership, leasing the equipment.
- A dealer in manufactured goods in Thailand will not accept any sort of collateral for its credit, which is short-term. Instead, it may give credit on a guarantee from a bank or the company's directors but it prefers to rely on criminal sanctions, using post-dated checks from the debtor. If the checks bounce, the debtor goes to jail.
- A PRC computer dealer gives credit rarely and then only to big companies, but when it does give credit it requires collateral in the form of negotiable instruments, certificates of deposit, and state bonds. It will not accept a security interest in the computers themselves that are in the buyer's possession.
- A Pakistani manufacturer of fixtures that gives credit only to dealers with which it has a good track record (not new customers), and only short-term, will not accept any collateral even though as many as 30% of the debtors fail to pay on time.

Source: Enterprise Interviews

government bonds (PRC),<sup>542</sup> or post-dated checks with criminal penalties for inadequate funds (India and Thailand<sup>543</sup>). Land is regularly and often exclusively preferred in Thailand<sup>544</sup> and, somewhat less, in Indonesia.<sup>545</sup> Even in India, land is frequently preferred by the creditors or required as well as other collateral.<sup>546</sup>

**(v) Enterprises Give Credit Without the Security of the Goods That They Sell or That are Produced From Those Goods**

392. Certain kinds of creditors would be expected to take a security interest in the goods that they sell or that are produced from the goods they sell. It comes as a surprise to discover that they do

<sup>542</sup>PRC Enterprise Interviews.

<sup>543</sup>India and Thai Enterprise Interviews.

<sup>544</sup>Thai Enterprise Interviews.

<sup>545</sup>Indonesia Enterprise Interviews.

<sup>546</sup>India Enterprise Interviews.

not. In this study, we discovered that most dealers in heavy equipment did not take a security interest in that equipment (Pakistan, Indonesia, and Thailand<sup>547</sup>). One that did so surfaced as an exception (Indonesia<sup>548</sup>).

**(vi) Enterprises Give Credit Secured by Hybrid Security Interests, Not by Strict Security Interest in Movable Property**

393. Hybrid security interests often finesse the problems creditors face when enforcing their interests in movable property the debtor owns and possesses. Hybrid interests such as conditional sales were used by dealers in computers (India),<sup>549</sup> fixtures (Pakistan),<sup>550</sup> and manufactures (Indonesia).<sup>551</sup> They were used by the third parties that financed cars (Indonesian<sup>552</sup> and Thailand).<sup>553</sup>

394. The advantage of hybrid security interests is seen in the Indonesian dealers in manufactured goods who lease rather than give credit against collateral. They use the lease for the practical reason that they will still hold ownership title over the goods being paid in installments, so that in the event of default, the respondent will automatically have rights to repossess the goods without having to pursue any judicial process.<sup>554</sup> Earlier chapters, however, raised doubts about the effectiveness of even these hybrids. The Enterprise Interviews reinforce these doubts. The hybrid security interests do not adequately reduce risk and cost. In Thailand, the third party creditors hire agents to repossess the vehicles outside the legal system. This repossession is still expensive, since the cost is 2-3% of the asset value, and takes 40 to 60 days. The agent either sells the vehicles privately or uses the dealer network to do so.<sup>555</sup> Sometimes the hybrid security does not expedite repossession. In India, the conditional seller must still use the courts to take possession.<sup>556</sup>

395. As a result, relatively few examples emerge from the fieldwork of enterprise credit secured by movable property owned and held by the debtor. Some examples are found in India,<sup>557</sup> where dealers that sell cars, brand name computers (i.e., not on the grey market), farm inputs, and heavy equipment do accept movable property as security. Even here the inadequacies of the law appear, however, making potential creditors reluctant to rely on the security of movable property. Farm input dealers take movable property, gold, and future crops as collateral, but the validity of the future crops as collateral is questionable because it has not been tested in court.

396. For heavy equipment, collateral is always in the possession of the buyer. Registration of a security interest in heavy equipment that does not amount to a fixture is neither compulsory nor deemed to be adequate notice to any subsequent purchaser. The creditor protects its interest in the collateral by painting the fact of hypothecation somewhere on the external surface of the equipment itself. Then all subsequent purchasers have notice of the encumbrance and are subject to the terms of the sale deed. The seller could either enforce the security against the original buyer or the later buyer.

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<sup>547</sup>Indonesia, Pakistan, and Thai Enterprise Interviews.

<sup>548</sup>Indonesia Enterprise Interviews.

<sup>549</sup>India Enterprise Interviews.

<sup>550</sup>Pakistan Enterprise Interviews.

<sup>551</sup>Indonesia Enterprise Interviews.

<sup>552</sup>Indonesia Enterprise Interviews.

<sup>553</sup>Thai Enterprise Interviews.

<sup>554</sup>Indonesia Enterprise Interviews.

<sup>555</sup>Thai Enterprise Interviews.

<sup>556</sup>India Enterprise Interviews.

<sup>557</sup>India Enterprise Interviews.

397. Used equipment is almost never taken as collateral as there is no foolproof way to ascertain that the used equipment has no prior charge on it (except where the complete property has been charged and the used equipment is a fixture within that property). Further, used equipment need to be independently valued, which may involve considerable time.

398. Under these circumstances even in India, the personal property fails to protect Indian creditors and give Indian debtors useful collateral.

**(vii) When the Same Enterprises Raise Debt, They Use Less Than One Would Expect of Their Own Movable Property as Security for the Credit to Them**

399. In India and Pakistan<sup>558</sup> particularly, debtors can offer certain kinds of movable property as security: floating charges on inventory that is not specifically identified, accounts receivable, identified equipment (farm inputs, general merchandise and fixtures in both countries but, only in India, dealers in autos, heavy equipment, and computers). In India, the inventory does not effectively have value as collateral. The debtors' general opinion was that increasing the value of their inventory would not increase their ability to raise debt and that financial creditors were more interested in the value of the dealers' real estate.<sup>559</sup> In Thailand, dealers' access to credit typically cannot be secured by their inventory or their portfolio of credit sales (accounts receivable or chattel paper). The problem is acute when dealers import goods. Title to the goods being imported is transferred (so the debtors believe) at the port of entry into Thailand. Dealers do not store imported collateral; rather goods are kept in a free zone warehouse to prevent them from clearing customs until there is an actual sale contract.<sup>560</sup> This slows production and raises costs.

400. Securitization links the enterprises in this section and the financial intermediaries in the next section. *Securitization* is a word with multiple meanings. In the broadest sense, it is the process by which a company or financial institution shifts some of its assets or liabilities to the securities markets to increase liquidity, change its balance sheets, or reduce its costs. Here securitization refers to "the process of converting loans or receivables into tradable investments."<sup>561</sup> Accounts receivable financing and chattel paper financing are two examples of securitization.

401. *Accounts receivable* are unsecured rights to receive payments. For example, a company that sells its goods and requires the buyers to pay in 30 days has accounts receivable from each buyer between the time of the sale and the time the buyer pays. Accounts receivable represent a substantial fraction of the assets of most companies. How well such accounts can serve as collateral has an important bearing in whether a company can transform its wealth into liquid funds that permit financing operations at a lower cost or expanding operations more rapidly.

402. *Chattel paper* describes collateral that is itself an obligation to a secured party. For example, a dealer may sell a tractor to a farmer on credit and take a security interest in the tractor. The dealer may then use that security interest in the tractor to borrow funds from a bank. The dealer either sells the security interest outright or gives the bank a (new) security interest in the (first) security interest. This is chattel paper. It can include financial leases, pledges, or real estate mortgages. The easy refinancing of debt portfolios is a key building block of modern financial systems.

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<sup>558</sup> India and Pakistan Enterprise Interviews.

<sup>559</sup> India Enterprise Interviews.

<sup>560</sup> Thai Enterprise Interviews.

<sup>561</sup> Morrissey, H., ed., *International Securitization* (1992).

403. In strong systems, bank and non-bank financial intermediaries securitize and refinance portfolios of leases, mortgages, automobile debt contracts, farm equipment debt contracts, and consumer credit. They even securitize and refinance portfolios of pawnshop credit. See Box IX-4.

**Box IX-4. Effects Of Legal Problems On  
Accounts Receivable And Chattel Paper**

The frameworks for secured credit in the five RETA countries studied do not provide for security interests in chattel paper or accounts receivable. Rather, they require transfer to the creditor of the accounts receivable or the chattel paper. Transfer results in impracticably large expenses for businesses with many small accounts; it is often a poor business practice even for large accounts.

These systems treat security interests in accounts receivable (not represented in a negotiable instrument) as an assignment of rights. These rules require transferring each account to the new creditor by notifying each one of the account debtors. The unreformed assignment of rights systems, as a means of securing credit, raises three important problems:

**(i) High Cost**

These systems require either court notification or the notarized consent of the debtor. Such methods incur a cost per transfer plus closing costs on the loan. Suppose a business applies for a loan secured with a portfolio of US\$10,000, representing 500 receivables of \$20 dollars each, and that these receivables expire in 30 days. A \$1 transfer charge represents 5% of the value of each account. Since these accounts expire at the end of 30 days, this amounts roughly to an annual rate of about 80%. The closing fees to pay for the loan to the business or the interest rate on it will increase this rate. Strong systems eliminate these fees.

**(ii) Increased risk from lack of registration**

When a security interest arises through the assignment of rights, these systems rank priority among assignees from the time the account debtors are notified or give their consent to the assignment. They do not rank priority from the time of filing in a public registry; indeed, they make no provision for public registration. Some creditors try cutting costs and make credit without actually transferring accounts, running the risk that the debtor has pledged the same accounts to another creditor.

**(iii) Increased risk from debtor notification**

Since their notice and consent is required, the account debtors learn that the local dealer is no longer the creditor. This can jeopardize the microeconomic link that assured repayment in the first place. The farmers' incentive for paying arises from concern about maintaining a relation with the local dealer from whom the farmer gets credit. The local dealer, not the distant secured creditor, knows the farmers and can ruin the reputation of the default debtor and limit their future access to credit. By contrast, the small producer will understand the distant refinancing bank has no interest in making a direct loan to the producer. Consequently, the producers will have a weaker incentive for paying the distant refinancing bank than the farmer's incentive for paying the dealer. The private bank, understanding this, will find the transfer of such portfolios quite unattractive and will not give credit to the dealer.

### **C. Credit by Intermediaries: The Financial Firms**

404. In general, the private banks (and also government banks) we interviewed make few credit secured primarily by movable property in the debtor's possession. The study separately discusses the government and state banks, given the view that state banks are more willing to make risky credit because of political mandates for some credit. A discussion of the way private commercial banks give credit against movable property, however, is appropriate because, at least in theory, they should be more sensitive than government banks to the effect of collateral on the risk of the loan, and therefore on its price. Typically, in these countries, the secured transactions law does not differ for private and government-owned banks, so the law as described for private banks also applies to the government-owned banks. When government-owned banks accept collateral that their private sector counterparts decline, one will lose. Either the government bank is making a mistake because the collateral is weak or the private bank is making a mistake because it could have made the loan against good collateral and failed to do take advantage of a good business opportunity.

#### **(i) Private Banks**

405. Private banks interest this study because their calculus of profit and loss should be sensitive to the risk that security interests remove, or fail to remove. As expected in the previous chapters, these banks offer only limited credit secured by movable property. Their role in the credit chain—financing against accounts receivable and inventories—is limited. They prefer real estate as collateral, but the movable property that they accept is generally transferred to their possession or titled (and therefore registrable). The following paragraphs explain these points.

##### **(a) Limited Financing of Movable Property**

406. Problems in the framework for secured transactions directly limit how banks can finance purchases of movable property by farms and businesses. Banks of the five RETA countries will not finance equipment, inputs or, for the most part, inventories, unless the movable property has a title-registration system (such as ships, airplanes, or cars) or the debtor turns the property over to the creditor. Most movable property used by producers has no title registration system. The movable property does the debtor little good if it is turned over to the creditor. The producer cannot use movable property to secure credit for expansion, working capital, or purchase of that property on credit.

407. Private banks demand that debtors seeking credit for these purposes offer other collateral—typically real estate, evidence of ownership of real estate, or the cosignature of someone who owns real estate. Such a system will fall far short of meeting the debtors' funding needs. It deprives micro enterprises, tenant farmers, and farmers without merchantable title to their land of all advantage from offering collateral.

##### **(b) Bank Refinancing of Dealers Who Give Credit and Sell on Credit**

408. In other countries, the dealers' accounts receivable, chattel paper, and inventories of new and used equipment all serve as collateral for the dealer's own credit from the formal sector. The dealers can raise funds by giving their creditors the instruments representing the debt owed to the dealers as collateral for new debt. However, problems in the framework for secured credit make banks and finance companies reluctant or unwilling to finance a dealer's stock of new and used equipment beyond the credit the dealer could obtain based on real estate holdings. Related problems in the framework for secured transactions make banks and finance companies indisposed to taking as collateral the debt contracts generated by the dealer. Limits on secured transactions in

these

countries, therefore, restrict access to credit through many channels. These channels in the industrial countries provide ample flows of credit to, for example, rural producers.

**(c) Banks Prefer Real Estate as Collateral**

409. Private commercial banks, with limited exceptions, give credit only to debtors who offer real estate as collateral for credit, to debtors who own real estate that the bank could attach in the event of default on an unsecured loan, or to debtors who offer the personal guarantee of someone else who owns real estate. Indonesian banks are an example. One reported 80 percent of its credit secured by real estate.<sup>562</sup> Another estimated that the ratio was between 55 percent and 65 percent.<sup>563</sup> A third reported 100 percent of its credit unsecured, but all of those made to well to do citizens who owned real estate.

**(d) Banks Prefer Personal Property that can be Placed in the Possession of the Bank**

410. Where banks did take personal property, they had, compared to banks elsewhere, a very restricted view of what was acceptable. One Indonesian bank accepted Certificates of Deposits (only its own, not those of another bank) or listed shares placed in its own possession. Another Indonesian bank would give credit against jewelry deposited with a jeweler if the debtor presented a certificate.<sup>564</sup> One Indonesian bank, in response to the question of whether it lent secured by personal property, immediately answered in the affirmative, that it would give 100% loan against, for example, a Certificate of Deposit ("cash collateral") placed in its possession. The bank had to be reminded to answer whether it took personal property as collateral when that collateral would remain in the hands of the debtor. That bank would finance fixtures only with a mortgage on the fixture and the real estate to which it was attached.<sup>565</sup>

**(e) Banks Accept Some Other Movable Property**

**(1) Cars**

411. Banks do accept cars as collateral for a loan or finance the purchase of a car. Several Indonesian banks specifically noted the special features they used to overcome the problems in the legal framework when financing cars. They avoided the problems discussed earlier in creating a security interest and establishing their priority by retaining the title to the car. They avoided the problems of the absence of a filing archive by annotating the title that they filed in the motor vehicles registry. They also avoided the problems of enforcement by relying on the cooperation of the police to enforce the title still held by the bank.<sup>566</sup>

412. Banks invoked the criminal legal system, since they were, not surprisingly, nervous about their reliance on holding title. One Indonesian bank noted the importance of using the local "police department to block any action that would inflict a loss on the creditor (by) selling the collateral."<sup>567</sup> Another Indonesian bank, also using this system, stressed that it was "only based on private

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<sup>562</sup>Indonesia Enterprise Interviews, 1.

<sup>563</sup>Indonesia Enterprise Interviews, 1.

<sup>564</sup>Indonesia Enterprise Interviews, 1.

<sup>565</sup>Indonesia Enterprise Interviews, 1.

<sup>566</sup>Indonesia Enterprise Interviews, 1.

<sup>567</sup>Indonesia Enterprise Interviews, 1.

cooperation...with the police department.”<sup>568</sup> For Indonesian banks, automobiles represented a special case: with a title registration system, an ability to annotate title, a police force with particular responsibility to recover stolen cars, and a technology that requires operation of a car in a public place, recovering a car is relatively simple.

## (2) Identifiable Equipment that is Not Titled

413. Banks in the civil law jurisdictions became considerably more wary when offered other machinery. For most other equipment, like other governments the Government of Indonesia does not support a "titling system"—ships and planes have titles, but other goods do not. These other goods include computers, generators, metal lathes—the constituents of the remaining 75% of the capital stock.<sup>569</sup> With no titling system, banks have no way to use the "automobile" system to prevent the debtor from selling the collateral. The bank would only have an invoice, by itself insufficient proof to a police officer that something was stolen. Moreover, other capital equipment does not often circulate on the public ways. Therefore, the bank could require some assurance of being able to enter premises and recover equipment. All banks interviewed remarked on the riskiness of this process, the absence of public registry for security interest, and the long court times required to get an order for repossession and sale.<sup>570</sup> One bank, having observed that under no circumstances would it give credit for machinery affixed to the building without also having the mortgage on the building, noted that it tried to compensate for these problems in the system by a system of inventories and spot inspections.<sup>571</sup>

414. Banks in the common law tradition loaned against untitled but identifiable equipment. All Pakistani banks reported taking as collateral the machinery of a firm, using a mortgage when it could be specifically identified and was fixed to the property or the floating charge when it was not.<sup>572</sup> Pakistani finance and leasing companies made similar loans, some of them financing equipment at rates and terms not much different from those in the United States, relative to home mortgage terms. One Pakistani company interviewed was firm in insisting that it was looking only to the equipment as collateral for the loan and not to any accompanying real estate.<sup>573</sup>

## (3) Other Collateral

415. In each country, the research revealed that private banks rarely give credit solely on the security of movable property in the possession of the debtor. The rare exceptions consist of movable property that can be registered. In Thailand, banks do not welcome personal property, but accept it generally in addition to real property. Thai banks rely on statutes that permit the creation of security interests, in the form of mortgages, over certain personal property, if that property can be registered or retained outside the debtor's possession. This movable property includes machinery, vessels of a specified tonnage, farm animals, and inventory (when stored in a licensed public warehouse). So banks make credit secured with personal property only if the property can be mortgaged, and therefore registered, or held in the actual or constructive possession of the bank. They do not use other forms of movable property as collateral. This limited use directly reflects problems in the

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<sup>568</sup>Indonesia Enterprise Interviews, 2.

<sup>569</sup>These numbers are set out earlier based on detail US Census numbers. Comparable figures were not located for Indonesia, but it is well established that countries with similar incomes per capita use similar amounts of capital per worker. Accordingly, the amount and distribution of capital shown for the United States gives a good idea of what the five RETA countries under review will require as they close the gap between their own incomes and that of the United States.

<sup>570</sup>Indonesia Enterprise Interviews, 2, 3.

<sup>571</sup>Indonesia Enterprise Interviews, 2.

<sup>572</sup>Pakistan Enterprise Interviews, 1.

<sup>573</sup>Pakistan Enterprise Interviews, 4.

general law on security interests, the Civil and Commercial Code (CCC). In Pakistan, banks only use personal property securing credit for working capital credit. The banks rely on the first mortgage,

which represents the first right on the collateral. They regard other instruments as too risky. They use only real estate for securing term credit.

416. Indonesian banks were well informed about the weakness of the legal framework for taking other movable property as collateral. All Indonesian banks reported that the law required specific identification of the pledged item, so they could not offer credit secured by generally described inventory. One noted reasonably that "it is difficult to specifically identify a changing stock of goods."<sup>574</sup> All banks reported that the only safe way to refinance accounts receivable was to transfer them to the bank and that they undertook only limited amounts of such financing because it was expensive and risky.

417. Banks in the common law jurisdictions do accept inventory as collateral under the laws governing charges.<sup>575</sup> Of course, as indicated in previous chapters, this possibility only applies to companies and the vast majority of operators of farms and business remain outside this legal fabric.

## **(ii) Government-Owned Banks**

418. Government owned banks are often assumed to be more willing to take risk because of politically-mandated objectives and the absence of private shareholders who worry about losing their money. In practice, however, the interviews reveal that they still give credit largely against real property, not differing much from their commercial counterparts. The study did not interview special purpose government credit programs for financing particular groups because it was thought that their behavior would give little information about the state of the legal climate for granting and collecting credit.

419. Some government-owned banks reported taking personal property as collateral. In Thailand, state banks until recently did not accept personal property as collateral. Now, under the Government's policy of promoting Small And Medium Enterprises (SMEs), state banks have a policy of accepting mortgage of machinery as collateral. In Indonesia, like the private banks, state-owned banks providing credit generally prefer the security of immovable property. However, special credit policies, such as its credit scheme, may allow the bank to take other personal property as security. These public banks, however, face the same problems in the legal framework as private creditors do. Taking movable property as collateral regardless of the problems may increase the number of non-performing credit for which collection presents difficulty. Debtors of state owned banks may find that because it involves state funds, a default to these banks has more serious consequences than a default to a private bank. As a result, state bank staff may use even more caution than private banks when they give credit and require even more collateral.

420. Banks in the public sector seem to be subject to almost the same formal rules as privately owned banks, yet differ in their credit and collection of bad credit. In Indonesia, state owned banks receive social missions from their governmental owner. These missions influence the state bank's use of collateral. In some cases, the banks require less collateral because they have instructions that they should give credit to key sectors. In other cases, the banks accept personal property as collateral that private banks would not accept. In neither case would the collateral affect the bank's allocation or perhaps even pricing of credit. The social mission guides these decisions.

421. India provides a case in point about how state banks follow the same formal rules yet differ in lending. The state banks follow the same procedures and rules governing creation, priority and enforcement of security interests that govern private banks. Bank supervision, and the rules about

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<sup>574</sup>Indonesia Enterprise Interviews, 1.

<sup>575</sup>Pakistan Enterprise Interviews, 1.

capital adequacy and bad credit provisions, do not treat credit secured by personal property differently from credit secured by real estate or unsecured credit. It seems that internal administrative procedures allow a banker to ask for secondary collateral in cases where he has cause for suspecting the value or legitimacy of a security interest offered in personal property by the debtor. Government owned banks do not have any legal procedures allowing them to register or collect credit secured with personal property that other creditors cannot use. Public banks differ because they give lower interest by about 2% across the board on credit and advances.

422. Special rules do govern the collection of credit made by certain government entities to industrial firms that default. The State Financial Corporations Act, 1951 in India provided for the establishment of state financial corporations. Where an industrial concern defaults on a loan, advance, or installment due to a state financial corporation, the creditor has the right to take over the management or possession of the debtor, as well as lease or sell the property pledged, mortgaged, hypothecated, or assigned to it.

### **(iii) Finance Companies and Credit Cooperatives**

423. The same basic rules governing secured credit apply to finance companies as to the banks. In the countries that allow accounts receivable and inventory to serve as collateral—India and Pakistan—the finance companies take these forms of collateral. In Indonesia, by contrast, the finance companies did not take collateral but relied on hybrids, leasing and factoring, to retaining ownership and avoiding courts. Thai finance companies declined to answer our questionnaire because they were subject to intense investigation in the wake of the Asian financial crisis.

424. The credit cooperatives' use of collateral varies according to the kind of cooperative. For the most part, the cooperatives did not use personal property in the debtor's possession as security. They would take possession of certain kinds of personal property (cash and securities, for example) and they relied on members' guarantees. In India, the law allowed only the limited liability credit cooperatives to take agricultural products as collateral, while in Thailand, they could take a pledge of the debtor's rice stock.

## **D. Problems with the Law Explain the Creditors' Behavior**

425. The law can enable debtors and creditors to use collateral, or it can disable them as well. Commercial banks in India and Pakistan take inventory and machinery as collateral because they believe the law permits them to do so with some safety. Banks in Indonesia (before the reform there), Thailand, and PRC refuse to do so, pointing to features of their laws that make such collateral unsafe. By way of contrast, laws limiting certain types of security interests to a specific class of debtor constrain the banks and allocate credit. In India, banks now use receivables to secure credit and credit lines, but they can only do this by using the company charge. The result is that the banks only provide credit secured by receivables to debtors that are companies. In Pakistan, banks give credit only to private and public limited companies and not to individuals or partnership firms. As shown in earlier chapters, law generates problems creating, publicizing and getting priority, and enforcing security interest, and each of these problems contributes to the others. In addition, tax law sometimes impedes the use of security interests.

### **(i) Limited Creation of Security Interests**

426. Uncertainty about the legal basis for a security interest in personal property undermines its use. In Indonesia, the legal framework that allowed creditors to take personal property as collateral remained limited to the Civil Code and Mortgage Law during this study. The use of non-possessory

movable goods by fiduciary transfer had no basis in legislation and no registration. Private banks reported that this weak legal framework subjected them to a high degree of uncertainty about how they would enforce security interests against movable property.

427. Future goods do not secure credit in India, according to banks and other financial institutions, because Indian law does not view future property as transferable, and thus it does not suffice as collateral. A subset of Indian banks will take security interests in movable property as collateral even though it has questionable validity. Rural and cooperative banks alone report taking future crops as collateral, on the grounds that this merely transfers current interests in future property. However, they acknowledge the risk of this instrument and expressed understanding that no judicial decision has yet tested its validity.

428. Inventory, which changes in nature, cannot serve as collateral in Thailand. Thai law offers no effective way to take security over inventory as no system of floating charges exists. To be effective, the parties must create the security interest anew at each transformation, an impracticable task. Accounts receivable suffice as "security"; and can be transferred. However, Thai law has no "assignment as security."

429. Hypothecation, the method to create fixed charges, is the principal instrument that creditors and debtors use as collateral in Pakistan. This interest does not create floating charges against rotating assets, such as inventory and account receivables, which are thus unavailable to non-corporate debtors. Liens are limited in practice to bank accounts and are not used to secure accounts receivable or trademarks.

**(ii) Uncertain Priority, Little Publicity**

430. Typically, the banks do not register security interests to establish and make public ranking of priority in collateral because the available registries are limited in scope or usefulness. The exceptions are registries for specific types of collateral or for companies. The inadequacies of these limited registries constrain the use of movable property as collateral. Two examples follow.

431. When registration is optional and grants no priority, many creditors do not register their interests in personal property that serves as collateral. In India, the banks do not register the agreements in the public registry because the law does not grant priority to these security interests by means of registration. Only in cases of charges created by a limited company must the bank register the transaction with the Registrar of Companies. This sets priority. However, this registration system only applies to companies. In the case of motor vehicles as collateral the Registrar of Companies Book can have an entry of the financing source under the Motor Vehicles Act, therefore providing an easy way to check any prior security interest. The law treats heavy machinery attached to real estate as immovable property and therefore the bank must register creation of security interest in it. Registration, however, takes about 15-20 days and the debtor bears the cost.

432. Uncertain access to registered data seems to discourage the use of certain assets as collateral. In Indonesia, no registration of security interests in personal property existed, but company books do contain registered information on existing security interests in shares. Access to the information for privately held companies significantly depends on the cooperation of the company concerned, as the company itself keeps and maintains the registration. As for public companies, relatively little charge applies for accessing such information. Mostly, access can require

the consent of the shareholder. As for reliability, for privately held companies, this again depends on the cooperation of the company. For public companies' pledges, the Shares Administration Bureau blocks shares and therefore cannot transfer or encumber them. As a result of these facts, creditors refrain from securing their credit with movable property. Movable property normally serves merely as complementary collateral for which creditors give no value.

**(iii) Slow and Expensive Enforcement**

433. The banks in all the countries described enforcement as a long and costly process. Each bank, not surprisingly, described a collection process along the lines of those outlined in the preceding legal analysis chapter. Lengths of time for enforcement were prodigious. Lengths of time reported by three banks in Pakistan, for example, ranged between 1 and 5 years.<sup>576</sup> They reported lengths of time of 3 months to six months for the sale process alone.<sup>577</sup> In Thailand, in the case of a mortgage of machinery where the mortgagor retains possession of the collateral, the bank must file a case with the court to take possession of the collateral and sell it by auction. Accomplishing this process could take up to 3 years, and great expense. In Pakistan, those interviewed estimated the entire process for repossession and sale of collateral up and until the actual payment of the sale proceeds to the creditor took an average of 5 years.

434. These long enforcement times are completely inconsistent with the economic and technical properties of most movable property. Some movable property is valuable but evanescent, such as stocks of seafood, flowers, and accounts receivable. Even longer lived equipment cannot maintain its value over such a period. Much chattel paper matures in 4 or 5 years, a car is substantially depreciated in that time. Bankers understand this well; as one remarked "machines depreciate... Land, on the contrary, is always saleable as it always appreciates."<sup>578</sup> Understanding this, banks in Pakistan and India shy away from movable property as collateral. Banks in Thailand, Indonesia and PRC largely decline it altogether. The bankers' perception is due largely to slow enforcement, as Chapter VIII shows.

435. Great uncertainty of outcome impedes enforcement. In Indonesia, IBRA mainly conducts current enforcement in the banking sector. Most respondents, who enter the recapitalization process, must transfer to it all their non-performing credit in return for the recapitalization funds. Enforcement is out of their hands. The normal process to enforce security rights in the event of default can bring many challenges and uncertainty, as described in the earlier chapters. The absence of a legal framework for non-possessory security interests has made the creditors in a fiduciary transfer quite uncertain regarding their rights over the encumbered goods. For example, even enforcing mortgage rights (especially junior mortgage rights) can often become quite tricky, and will cost a relatively large amount of money. In the event of controversy, obtaining a final settlement or binding decision can require much time. For movable goods, even worse problems exist. In one case, resolving a dispute over the personal property of a debtor encumbered by fiduciary transfers required six creditors to go to court six times. As a result, respondents in this category often consider that the fiduciary transfer of movable goods gives only an emotional bond that scares a debtor into fulfilling its obligation. This may also represent the reason why most respondents in financial institutions always choose the personal approach in the event of default, because the respondents usually know that enforcing the fiduciary transfer in the courts will have uncertainty.

436. The cost of enforcement is usually high. In Thailand, the official fee for a court-supervised

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<sup>576</sup> Pakistan Enterprise Interviews, 3.

<sup>577</sup> Pakistan Enterprise Interviews, 3.

<sup>578</sup> Pakistan Enterprise Interviews, 3.

public auction in the case of a mortgage is 5% of the sale proceeds. In the case of a pledge, a

professional agent usually charges a percentage of the value of the property sold. The percentages vary from 1% upwards, depending on the value of the property.

437. Self-help can speed the process, though it is not available in Indonesia or Thailand, where enforcing a security interest requires use of the courts. In India, in contrast, upon default the bank notifies debtor of the default and the bank's intent of enforcing the security interest. The procedure for taking possession of collateral depends on the type of collateral. If taking possession can occur without requiring a right to entry (with a car, for example), possession agents take it and bring it to the custody of the bank, which completes and dates previously signed forms assigning the vehicle to the financial institution. If the possession of collateral, like a household computer, requires a right to entry then the bank seeks permission to enter and take possession of the collateral. If the debtor refuses permission when provided with a contractual right to entry, then the possession agents get police assistance in entering and taking possession of the goods. In practice, however, even banks are reported to use strong-arm tactics to repossess collateral.

438. These problems augment the others just described. A weak judiciary encourages banks to choose forms of collateral that can circumvent the courts. In Indonesia, most banks try to avoid court proceedings that enforce security interests in many types of movable property by taking only liquid and enforceable property. The fiduciary transfer of ownership carries substantial risk when the banks try enforcing it and remains quite unpopular among them. Banks facilitate enforcement of legally weak security instruments by using supplementary legal devices. In India, banks supplement the pledge or hypothecation of personal property with a signed power of attorney or transfer instrument that they can use should default occur.

439. Political influence over enforcement influences the choice of collateral because it affects the collateral's usefulness. One finance company raised an interesting concern about collateral. Explaining why the company would finance urban industrial equipment but not agricultural equipment, the manager remarked that "it is difficult to lay hands on the security (equipment) because the wealthy rural people are very influential and powerful." This leads financial creditors to prefer real estate or cash collateral, and only take as collateral movable property that they may easily repossess.

#### **(iv) Some Taxes Impede the Use of Some Types of Collateral**

440. Transaction taxes can make a secured transaction too costly. India's high stamp duty taxes their creation. Financial institutions report stamp duty prevents them from accepting as collateral heavy machinery attached to real estate. Mortgages may treat heavy machinery as immovable property and often take it as collateral. English Mortgages must be registered and is subject to a high stamp duty. The common effort to reduce, eliminate, or by-pass stamp duty leads to creation of the security interest by depositing a title deed (ownership papers). As a result, creditors do not legally perfect the mortgage and set a ranking of their priority to collect against the equipment that is collateral. Upon default, other creditors could set them aside.

### **X. OPTIONS FOR REFORM**

441. This report examines the effect that problems in the legal systems of five RETA countries have on credit and debt secured by movable property. The particulars vary by country, but the conclusion is remarkably consistent.