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FINANCIAL SECTOR KNOWLEDGE SHARING

FS SERIES #10: ESTABLISHING MODERN SECURED FINANCING SYSTEMS IN DEVELOPING ECONOMIES

PRIMER

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ACRONYMS

BiH	Bosnia-Herzegovina
EGAT	Bureau for Economic Growth Agriculture and Trade
FS Share	USAID Financial Sector Knowledge Sharing project
IFC	International Finance Corporation
IT	information technology
OAS	Organization of American States
PMSI	purchase money security interest
SBO	small business owner
SME	small- and medium-sized enterprise
SOW	scope of work
UNCITRAL	United Nations Committee for International Trade Law

INTRODUCTION

In 2008, USAID's Bureau for Economic Growth Agriculture and Trade (EGAT) created the Financial Sector Knowledge Sharing Project (FS Share). This project was designed specifically to collaborate with USAID missions to develop effective and efficient financial-sector programs that increase access to financial services and develop well-functioning markets globally. USAID awarded Chemonics International Inc. the FS Share delivery order under the Financial Sector Blanket Purchase Agreement. FS Share has a three-year period of performance, July 2008-2011.

Through the FS Share task order, USAID EGAT and Chemonics proactively collaborate with missions to identify financial-sector priorities and develop strategies and programs for growing the financial sector. FS Share identifies financial-sector best practices and aggregates them through model scopes of work, primers, diagnostic tools, best-practice case analyses, and other tools. These deliverables are disseminated to USAID missions for use in financial-sector programs. FS Share can also assist with implementation and connect mission staff to external resources on best practices. In response to mission demand, FS Share delivers presentations and other knowledge-sharing endeavors.

Objective of This FS Series

The objective of this FS Series is to provide U.S. government program designers with a basic technical understanding of the core requirements to introduce finance secured by movable property, one of the most important tools to increase access to finance, especially for small- and medium-sized enterprises (SMEs). It is designed to convert lessons learned and best practices into effective financial systems that enable long-term economic growth and expansion. The Series' primer provides an overview of the technical background and rationale for secured financing reform, and a detailed description of the components a reform program should include. The diagnostic checklist is a simple tool to evaluate the feasibility of reform and help prioritize issues. The model scopes of work give program designers a foundation to procure a baseline assessment of current conditions and implement a successful reform.

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FS Share Rapid Response Hotline

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EXECUTIVE SUMMARY

The relevance of secured or asset-based finance to the development of emerging financial markets is that it enables private capital to be used as credit to create new businesses and expand existing ones. For example, it may allow manufacturers and farmers to acquire new production equipment and fertilizers, and consumers to acquire new consumer goods. The terms on which lenders make credit available to borrowers depend on a variety of factors, including the lenders' cost of capital, the transaction costs to make the loan, and risks the loan will not be repaid. Higher costs and risks result in smaller, shorter loans at higher interest rates. Ideally, modern secured financing systems aim at increasing credit security, reducing credit risk, and consequently decreasing lenders' disincentives to grant more credit on better terms.

Property used as collateral to secure repayment is the "security" in secured financing. It provides lenders with an alternative to recover the credit if the borrower fails to perform. For collateral to fulfill its intended function and produce better credit terms, creditors must be able to convert it into cash in an efficient, low-cost enforcement process.

There are several reasons why movable property is often not used or underused as collateral in developing countries: information about borrowers' creditworthiness or the status of collateral is weak or absent; political and economic conditions are unstable; and mechanisms to enforce collection are costly and unreliable. Insufficient collateral is often cited as a reason why lenders reject loan applications (IFC, 2010). Traditionally, land has been looked upon as the best way to secure obligations. However, the volume and value of loans secured by movable property in developed economies have proven that movable property can play a significant role in generating credit because:

> **Movable Property**
>
> Movable property is a generic term that refers to everything other than immovable property. The term includes tangible property such as equipment, inventory, and agricultural products, and intangible property such as account receivables and intellectual property.

- The total value of movable property in a developing economy is often an untapped source of collateral. Individual items are sometimes more valuable than land parcels.
- The legal regimes that regulate land are complex and can impede efficient description, usage, or enforcement of rights against land.
- Land is sometimes subject to conflicting ownership claims.
- Many businesses, particularly SMEs, and consumers do not own land, but almost all own some form of movable property (e.g., inventory, equipment, crops, intellectual property, consumer goods).
- Often, more flexible loan products can be designed using movable property, particularly with respect to commercial transactions that provide credit to acquire assets that serve as the collateral for the loan.

A sound secured financing regime serves as the "traffic controller" of *all* financial vehicles that rely on movable property, often the exact same property. It may prevent conflict among different financial instruments (e.g., loans, leases, and conditional sales of goods), providing each with knowledge of "who else is on the road," and helping to avoid surprises and eliminate opportunities to engage in fraudulent transactions. In an ideal modern secured financing regime,

the relationship among claimants to movable property, regardless of what legal form gives rise to the claim, is regulated by a transparent and simple system of registration and rules of priority. This enables all financial service providers to calculate and reduce the risk associated with advancing secured credit, no matter on what form. Secured financing systems, therefore, allegedly promote a more stable, lower-cost, and less risky financial environment.

Secured financing is often associated with banking loans. Banking institutions are usually the primary users of the system, but microfinance organizations, leasing companies, government agencies, non-banking international creditors, and other types of financial institutions also use movable property as security for the finance they provide. A well-designed secured financing reform program will facilitate increased activity among all financial institutions, contributing to larger volumes of all loans, including micro and macro loans, and leases, to all sectors of the economy.

A secured financing reform program has three major components:

- *Legal reforms* modernize the secured financing regime. Reforms include simplifying the process of granting secured credit, clarifying the lender's rights against the collateral with respect to the borrower and third parties, and providing mechanisms for simple publication and effective enforcement of these rights.

- *Registry reforms* create or modernize the process of registering claims against movable property so they are publicly recorded and easily accessed. This reform usually involves computer technology to streamline and automate the registration process and to publish registered claims.

- *Capacity-building* is required to help stakeholders understand their role in the new regime, ensure that it is implemented, and ensure that businesses and consumers have more access to credit on better terms. Local capacity-building primarily targets financial institutions, businesses, lawyers, the judiciary, enforcement officials, and academic institutions.

Recognizing the potential for using movable property as collateral to expand access to credit, the international community has implemented many secured financing reform projects worldwide. Jurisdictions that have established modern and efficient secured financing systems have managed to remove some of the risk barriers to granting credit, especially to SMEs, but also to other sectors of the economy, including business, industry, farming, and consumers (IFC, 2009).

The experience of the international donor community illustrates that success in establishing an effective and sustainable secured financing system is typically greatly dependent upon the availability of technical expertise and financial resources. International experience also shows that greater expertise reduces the financial cost to implement reform. The more challenging part for donors can be the capacity to identify the most suitable development program, including the extent of the law reform, selection of the registry system, and mapping out (and executing) the steps necessary to implement. The case studies in this primer are intended to shed light on some of these considerations.

Modern secured financing systems can have regional and global applications. As capital and movable collateral travel across borders, they are often subject to different legal systems. A consistent approach to secured financing reform among jurisdictions facilitates the advancement of credit because lenders can predict their ability to enforce their rights regardless of where the collateral is located. Approaching secured financing as a regional or a global reform has the potential to dramatically increase the value of movable property as security.

The goal of this FS Series is to present best practices in the design and implementation of modern secured financing systems reform programs. This document provides an overview of the structure and implementation of reform programs in this area. However, during implementation, special attention should be directed to the United Nations Commission on International Trade Law (UNCITRAL) *Legislative Guide on Secured Transactions* and the International Finance Corporation (IFC) *Secured Transactions Systems and Collateral Registries*.

PRIMER

This primer describes the role of secured financing in a modern economy and explains the essential features of reforms to legislation and the related implementing institutions within which secured transactions occur. It also provides an overview of the most important features of modern secured financing systems and the principal steps involved in implementing such a system. In the primer:

- *Section A* introduces secured financing systems, explaining the economic rationale of secured financing and its main functions.
- *Section B* reviews the main components of modern secured financing systems, including the legal and registry systems. It includes references to relevant literature and important new considerations.
- *Section C* discusses the main functions of the system, including allowing risk assessment for all types of financial devices that produce claims to movable property, reducing the costs and risks of engaging in secured credit, and enforcement of rights against movable property.
- *Section D* describes the four main components of a reform program: the preliminary diagnostic phase, legal reform, institutional reform (the registry), and building local capacity.
- *Section E* includes seven case studies. The first two feature full analyses of interventions that took different approaches, plus a set of lessons learned. The other five case studies are shorter and provide specific lessons on specific aspects of the reform.

A. Introduction to Secured Financing Systems

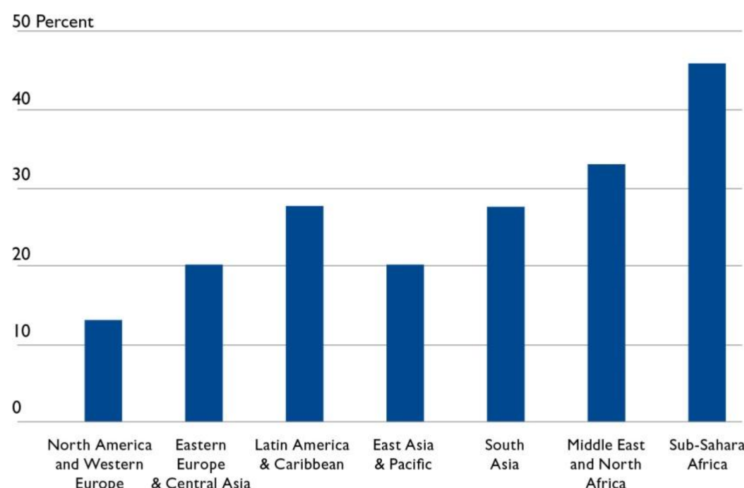
The availability of financing is a key factor in the development and growth of national economies. A single parent who earns a living from making and repairing clothes needs a good sewing machine. A farmer who wishes to increase production requires fertilizer, higher-yielding seed, better quality livestock, or more efficient farm machinery. A small retailer needs inventory for resale, and a construction business owner must acquire construction machinery. Public and private noncommercial organizations need finance to acquire equipment for desalinization, transportation, or medical purposes.

In some cases, businesses or others players in the economy may have sufficient internal capacity to generate cash flow or employ self-financing. However, in most cases, self-financing alone is not sufficient to initiate new commercial activities or expand existing ones. This is why all levels of business enterprise and other sectors of developed economies employ credit facilities.

Credit is risky; lenders will insist on reducing risk to an acceptable level before they consider providing development credit. Credit providers in many developing countries employ unsophisticated lending practices designed to reduce risk that increase the cost of credit. These measures include small loans, short-term financing, high interest rates, and heavy collateral requirements (IFC, 2009). These are poor substitutes for risk control. Although such measures can provide a hedge against default, they reduce access to credit and inhibit economic growth. Potential borrowers who are unable to comply with such requirements are excluded from the

credit market. Those who are able to borrow generate lower profit margins and accumulate less capital because of the high cost of and narrowed access to credit.

Exhibit 1. Share of Firms Identifying Access to Finance as a Major Constraint



Source: Realizing the Potential of Africa's Youth, 2009, chap.1.

Modern secured financing systems provide less costly and more effective ways for lenders to mitigate risk, allowing lenders to provide more affordable credit on better terms to all sectors of the economy (USAID*,* 2010*)*. These systems have three main characteristics:

- *Debtor-creditor relationship*. Secured financing involves a debtor-creditor relationship where a lender grants financing to a borrower for general use or for financing the use or purchase of specific goods. The lender secures his or her right with an enforceable, legal interest in movable property that provides an alternative source of recovery should the borrower default.

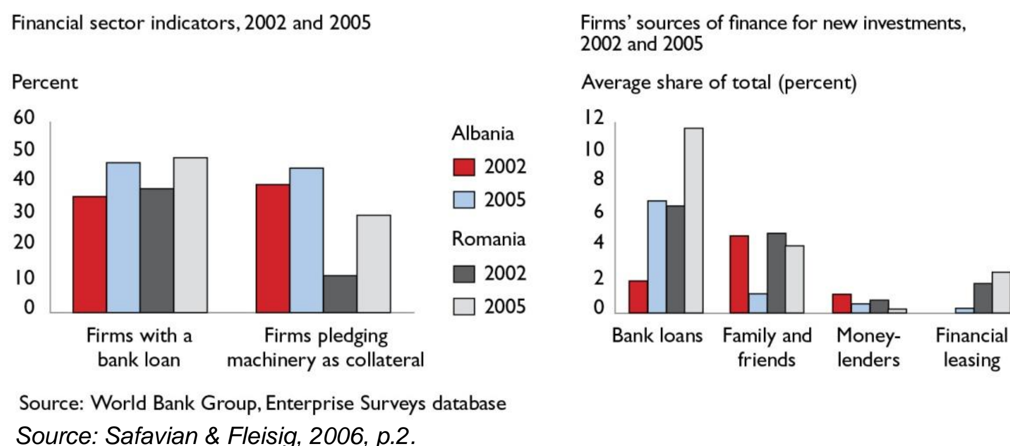
- *Protection against other claimants*. Modern secured financing systems allow lenders to determine with certainty what interest in collateral they are taking before making a loan. This enables them to ensure they acquire the *highest possible priority* over other claims to the same property, including the claims of buyers of the property, other creditors, and the debtor's bankruptcy administrator. This right depends on filing notice to third parties, usually by registering a notice in an electronic public registry.

- *Efficient enforcement*. Lenders are not required to obtain a court judgment to enforce their rights to have collateral seized, sold, and the proceeds applied to their loans when debtors default. Efficient systems permit seizure and sale by lenders with minimum official state involvement.

Over the past two decades, many countries have attempted to introduce modern secured financing laws like those in developed jurisdictions with established modern systems. Examples include Albania, Bosnia-Herzegovina (BiH), Bulgaria, Cambodia, China, Georgia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, and Slovakia. Other jurisdictions are in the process of or about to initiate such reform. The global financial crises that began in late

2008 highlighted the importance of secured financing in mitigating credit risk. (IFC, 2009). The increased number of secured financing activities is further evidence of the increasing recognition of its importance for enabling economic development.

Exhibit 2. Reforming the Collateral System Improved Access to Finance in Albania and Romania



Source: Safavian & Fleisig, 2006, p.2.

The pattern followed by almost all international reform initiatives that have implemented modern secured financing systems has been to provide separate systems dealing with interests in immovable and movable property. The principal reason for this is that creditors' rights in immovable property are grafted onto a complex body of pre-existing legislation that defines all other types of interests in such property, including ownership interests. Generally, secured financing systems applicable to interests in movable property have a much narrower scope and, consequently, can be implemented with much less disruption to other aspects of movable property law.

Regional and international organizations such as the Asian Development Bank; the European Bank for Reconstruction and Development; the Organization of American States (OAS); UNCITRAL; and the IFC of the World Bank Group have promulgated model laws and reform guides to assist member countries to establish simplified and effective modern secured financing systems. USAID, the World Bank, and other international donor organizations have also provided financing and expertise for the design and implementation of secured financing systems.

B. Main Components of Secured Financing Systems

Secured financing systems have two main structural components: a legal regime and a registry for publishing and searching for claims of interests in movable property.

B1. The Legal Regime

The core of a modern secured financing system is the legal structure through which essential features of the legal relationships among the creditor, the debtor, and third parties are regulated. The legal details of modern secured financing law are beyond the scope of this primer. Other

sources are designed to deal with these details to a large extent; they are mentioned in this FS Series. However, there are key features that distinguish a modern, efficient system from other systems that do not provide the optimum legal structure for the development of the secured financing market:

1. *Definition of terms and scope*. Because modern concepts are introduced as part of legal reform, the law should provide a set of definitions codifying new concepts in terms that are familiar to local law and practice. The scope of the law should also be defined, ensuring it captures all major types of transactions that create risk to third parties because they separate property interests from possession of movable property. The types of notices that should be required to be publicly registered as creditors' protection against third parties claims include:

    - Lender's notice that the borrower's collateral secures a loan
    - Lessor's notice that property will be repossessed if the lessee's defaults
    - Conditional seller's notice that it will retake possession of its property if the buyer defaults on paying the full purchase amount
    - Notice by public agencies that impose a lien on a person's property

2. *Clear definitions of rights in types of property*. The law must contain clear rules setting out the minimum required conditions to establish the lender's rights in regard to the borrower's property under any transaction within the scope of the law. Clear rules allow lenders and borrowers to tailor their legal relationship and their agreement to their special needs. The law should also allow the parties to agree that the lender's security interest covers present and future property, and the proceeds of any covered property (e.g., milk from the cow or money received from the sale of inventory). The law should allow all types of collateral and explain special cases for certain types of collateral. Inventory, accounts receivable, warehouse receipts, and crops are types of collateral that require clear rules for efficient use. Finally, the law should give the parties freedom to agree that the contract can be enforced without court proceedings if one of the parties defaults.

3. *Priority rules*. A secured financing law must contain a set of rules determining in what order conflicting claims to the same asset will be satisfied. This empowers lenders to predict, before the credit is granted, the priority their interest will have if the debtor defaults. The goal of the system is to facilitate risk assessment by lenders before the credit is advanced. Necessarily, this must be possible without the need to rely on post-default judicial procedures or application and interpretation of complex legal rules or post-default findings of hidden facts. Priority must be based on the fact and timing of publication. Rules of priority may also reflect policy considerations designed to strike a balance among all conflicting claimants, whether secured or unsecured. For example, some countries give workers or tax claims elevated priority, promoting policies such as tax collection or reduction of poverty levels. The trade-off for advancing such claims is that lenders may require more collateral or provide less credit because their rights are diluted. It is essential that a purchase money security interest (PMSI) always have first priority. PMSI arises when a lender advances credit for the borrower to acquire a specific

asset that becomes the collateral for the loan. It increases competition among lenders because it allows borrowers to shop around for the best terms.

4. *Enforcement of legal rights*. A modern secured financing law must contain a timely, efficient, and cost-effective mechanism to enforce the rights of lenders and borrowers. For example, in the case of movable property, this entails the possibility for lenders to repossess property from borrowers without court proceedings. It may include alternative dispute resolution and procedures for the parties themselves to dispose of the property without going through state mechanisms.

5. *Legal rules pertaining to the registry*. The secured financing law must contain provisions for the creation of a modern registry to record claims against movable property. The rules also include provisions defining how to create, amend, and delete registrations.

B2. The Registry and Publication System

A central aspect of any modern secured financing system is publication of information about claims against movable property. Access to complete, timely, accurate information about the status of claims to property is critical to avoid struggles over priority among parties that are asserting different rights — as buyers, lessors, lessees, or other secured or unsecured creditors.

Because a registry is so important in a modern secured financing system, it must be easily accessible, and registering claims and searching for others' claims must be efficient and cost-effective. Detailed descriptions of the design and operation of these registries can be found in the IFC's *Secured Transactions Systems and Collateral Registries Guide* and the Asian Development Bank's *Guide to Movables Registries*.

B2a. A Unified, Centralized, and Transaction-Based Registry

All claims to interests in movable property, including vehicles, should be registered in a single, centralized registry. (A possible exception to this is specialized registries for specific types of property, such as intellectual property and corporate securities.) A secured financing registry is essentially *a transaction-based registry*; registrations do not depend on the type of asset involved. Even mortgages on real property could be registered (although this FS Series does not include mortgages as part of the reform and does not discuss the implications of including them in the registry database). The registry's purpose is to collect and publish registrations of claims resulting from any transaction captured by the scope provision of the law, described above.

Another feature of centralization concerns the number of databases used in a jurisdiction. One is sufficient; more than one becomes unnecessarily complicated and ineffective. The global trend is to unify databases internationally to reduce risk and transaction costs, and unified databases are even more important in individual jurisdictions. Countries in which local political subdivisions have legal jurisdiction over secured financing law often have separate registries, which increases lenders' costs and risks. Movable property that is registered in one jurisdiction may not be protected by a competing claim in another. To be secure in this situation, a lender must search and register in multiple registries. Localizing the registry interface in a single jurisdiction, storing

local data in a central database, and enacting common rules for all sub-units can eliminated the inefficiencies that arise when there is more than one registry in a single jurisdiction.

B2b. Online Database

All modern registries use computers and information technology (IT) to archive and retrieve registration data relating to secured transactions. The most modern registry systems, which are Web-based, have been designed to permit only direct electronic entry and searches of registration data. Such online registry systems require creditors to directly register their own claims and do their own searches for prior claims. To register, they enter and transmit their data through the Internet, directly to the database. Those seeking information from the registry must also conduct online searches — and interpret the results for themselves. Intervention by registry officials is unnecessary and increases infrastructure costs, lenders' risk and transaction costs, and may make the registry susceptible to mistakes.

Frequent registry users such as financial institutions have direct access to the database from their computer systems. Casual users or those who have not made arrangements with the registry for direct access must use government agencies' facilities or pay a small fee to a private provider that offers direct access to register or search.

Allowing alternative, non-electronic access methods is a common mistake. In some jurisdictions, people can access the registry by submitting forms directly to the registry (in person or by fax). Registry personnel then enter the data and deliver the results to the customer. Having registry personnel as "middle men" wastes time and increases costs, and in practical terms is never necessary (when access to computer technology is a problem). The advantages of an online registry include:

- It is much less costly to operate because users do the registration and searching.
- Lenders have complete control over what is transmitted to the registry, the timing of registration, and any amendment to or discharge of a registration.
- The potential for error, omission, or fraudulent conduct on the part of the registry staff is eliminated and the registry's liability for improper operation of the system is dramatically reduced.
- Those without direct access to registry services can use private service providers to process paper-based requests for registrations and searches on their behalf. However, the archived information archived remains electronic and the service providers, not the registry, are liable for any errors.
- This system aligns risks and responsibility to create appropriate incentives. Lenders, who have the most to lose, have the responsibility — and the right and ability — to register timely, accurate, claims that will secure their positions.

B2c. Notice Registration

A modern, computerized registry system provides for notice registration, not registration of rights. Notice is not proof of the existence of the right registered; it is merely notice that the right is claimed. Unlike a registry that requires proof that the right exists, a notice-registration system does not require the actual agreement or a copy of it to be tendered to the registry. Instead, creditors submit registration information in standard digital format.

Creditors filing claims must provide only the basic facts necessary to alert third parties of the existence of potential claims against identified property. The only information necessary is to identify the borrower and the lender and to provide a description of the collateral. Providing further details creates possibilities for errors. For example, counterparts often want to mandate disclosure of the amount of the claim or loan, or the value of collateral. This complicates use of modern financial vehicles that create contingent claims to be defined by future events. It exposes the borrower's finances to competitors and the public at large.

Because the registry can provide few details about a claim, modern systems include a procedure by which third parties can access more information directly from one of the parties. This addresses concerns about the publicity of private information. A notice-based system is a prerequisite for an efficient, low-cost registry. Lenders are allowed to file their claims directly, precisely because they are only notices of claims. A rights-based system would require that registry officials themselves determine the validity of the right asserted before registering. This would, as noted, be costly and inefficient for all concerned.

B2d. Registration: Search Criteria

A computerized registry system must employ protocols for indexing and retrieving data from its database. A protocol defines the criteria — the specific items of information under which a registration is archived and retrieved by users. Secured financing laws usually (and should) provide that a registration is valid only if this information is recorded accurately.

The criteria for registration and for searching must be identical. Existing systems use one, sometimes two, types of information as publication-search criteria:

- *Debtor identifier*. This protocol requires that registrations include a unique identifier for physical and legal persons. Government-issued personal identification numbers for physical persons or tax identification numbers for legal persons are common criteria. The debtor-identifier search criterion allows a single search to capture all registrations of claims to all types of property indexed under the unique identifier of a specific borrower. Except for the cases described below, many times property cannot be described in a registration other than by a generic description (e.g., "inventory," "future property," "agricultural production," or "livestock").

- *Specific property identifier*. This protocol is designed to disclose *all* registrations regarding claims against specifically identified property. The criterion will usually include a specific identifier embedded on the body of the property, such as the chassis number in the case of vehicles. When it is available, a property identifier is the most efficient registration-search criterion for an electronic registry system because it allows the capture of all claims recorded against the specific property, including those recorded when the property belonged to previous owners.

C. Main Functions of Secured Financing Systems

C1. "Traffic Controller" of Secured Transactions

Secured financing promotes a stable financial environment; it is an umbrella term that encompasses all financial transactions secured by rights in property. It provides a common

platform for all commercial transactions involving movables as security to develop and operate without colliding or conflicting with each other or, even worse, creating new opportunities for fraudulent transactions. It therefore reduces the risk of collision among property rights that arise from multiple secured transactions. It also harmonizes reform efforts, each of which may attempt to introduce or develop different financial vehicles involving movables.

The following examples illustrate conflicts or fraudulent practices that may result from uncoordinated reforms to commercial transactions involving movables. The examples are followed by a description of the one common mechanism used by modern secured financing systems to prevent disruptions to the commercial activities and financial transactions that involve movable property. Though the scenarios are not taken from any particular jurisdictions, they represent potential issues that arise from existing reformed legal systems.

C1a. Secured Loan and Sale

Scenario: Credit Bank gives a loan to a woman that is secured by her vehicle. The woman sells the vehicle and then defaults on the loan. Credit Bank and the purchaser claim priority to the vehicle.

Conflicting Reforms: A reformed sales law provides that the purchaser has priority and therefore gets good title in order to facilitate commercial sales activity. A reformed secured financing law provides that Credit Bank has priority in order to reduce risk and increase access to credit.

C1b. Secured Loan vs. Secured Loan

Scenario: Bank A grants a two-year loan to Maize LLC, a farming business, secured by Maize's future maize production. Maize needs further financing and asks another bank, Bank B, for a loan. Bank B agrees to grant credit secured by all of Maize's present and future property. One year later, at the end of the harvest season, Maize defaults on both loans. Bank A and Bank B each claim priority over the harvested maize. Lenders are not required to register their claims to protect third parties.

Issue: Undeveloped secured financing legislation is likely to provide that Bank A has priority because it signed the contract first. Bank B decides that using movable property is too risky, and vows to never make a similar loan again. Bank A does the same, because it never wants to be in the position of Bank B. Access to credit is diminished.

C1c. Financial Lease vs. Sale Transaction

Scenario: Easy Lease, Ltd. enters into a financial leasing agreement with Fresh Water, Ltd. to purchase a new offshore water desalination system for $250,000. Under the lease agreement, Easy Lease retains ownership of the system until it is repaid the full purchase price. After paying $248,000, Fresh Water sells the system to Clearwater, Ltd. Fresh Water then defaults on the last payment of $2,000 under the leasing agreement with Easy Lease.

Conflict: Easy Lease claims that, as the "owner" of the system, it has the right to seize and retain the system from Clearwater and to keep the $248,000. This outcome makes leasing more

attractive for lessors but increases the risk to third-party purchasers. Clearwater claims it paid the full purchase price to Fresh Water and should have priority as a good faith purchaser. This result encourages commercial sales, but deprives lessors of their expected income in favor of subsequent buyers.

C1d. Financial Lease vs. Tax Lien

Scenario: Finance, Ltd. agrees to finance the acquisition of food-processing equipment by Africa Good Food, Ltd. Africa Good Food defaults on repayment of the loan. When Finance attempts to seize the equipment, it discovers that the income tax department has put a new lien on all of Africa Good Food's property, including the food processing equipment.

Conflict Issue: Who has priority? Tax law grants the Tax Department priority in order to increase tax revenues. Contract law gives Finance priority, which protects private parties at the expense of the public purse.

C1e. Security Interest or Financial Lease vs. Sale and Lease Back

ProWood is a small business that produces wood furniture. The company needs cash to pay its bills. ProWood asks Leasing, Ltd. to provide it with $50,000 on the following terms: ProWood will sign a sale and financial lease-back contract with Leasing. The leasing company will purchase a used wood-processing machine (value $50,000) from ProWood and will immediately lease the machine back to ProWood for total payments of $55,000.

Issue: Leasing, Ltd. agrees in principle, but refuses to sign the contract because it has no means to determine whether the machine is free of any existing claim against it.

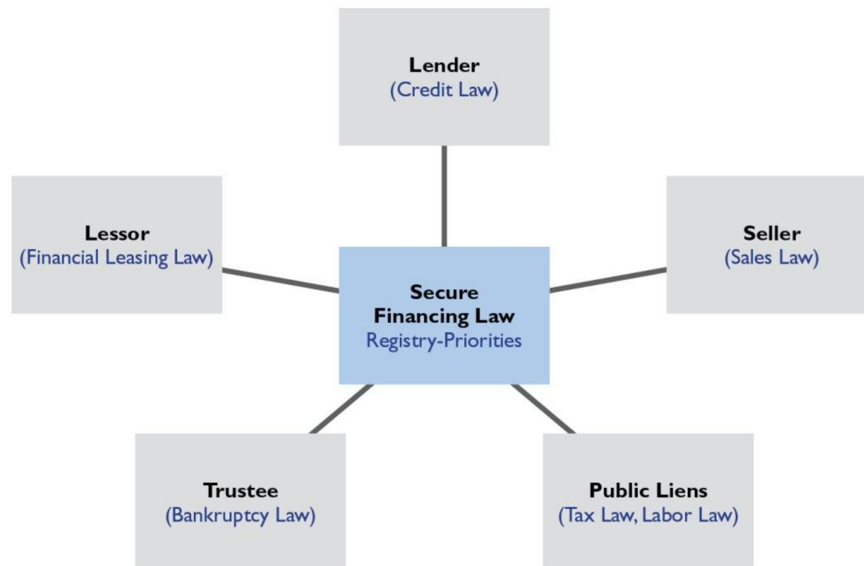
C1f. The "Traffic Control" Solution

Leave traffic control (priorities) to secured financing law. A central, indispensible feature of a modern secured financing system is a set of legal rules, called priority rules, that permits a high level of legal risk assessment without the need for judicial interpretation and application. To a considerable extent, the value of secured financing depends upon these priority rules (Jackson & Kronman, 1979, p. 1143). Priorities give lenders and other people (e.g., buyers and those who deal with property) the opportunity to assess their risks and protect their claims on the basis of publicly disclosed information about the existence of interests in property.

For the most part, legal rules determine which creditor has priority based on the information disclosed in a public registry. This is the "traffic controller" that allows all commercial transactions to function without the risk of collision or conflicts. Furthermore, legal rules prevent collusive agreements designed to defeat existing property rights. In the examples above, a legal rule that requires claimants to publicly disclose their claims of interest as a condition for taking priority protects both claimants and subsequent third parties (i.e., buyers, lenders, lessors) by providing them with the information they need to decide whether to deal with the property. A predictable and clear set of priority rules eliminates the risk of loss associated with "hidden claims" that may be concealed intentionally or unintentionally. These rules, therefore, should to be

embedded in a single secured financing law that overrides any conflicting provisions in other legislation.

Exhibit 3. Priority Rules



Priority extends to the contractual obligation only. Modern secured financing systems strike a balance between the rights of lenders and borrowers by recognizing that equity in property that is used as collateral, leased, or sold conditionally belongs to the borrower. As a result, upon termination of such credit agreements, any equity balance goes to the credit recipient, whether formally denominated a borrower, lessee, or buyer. This rule is essential because it reduces risk throughout the credit system and increases access to credit. The priority creditor receives the full benefit of its bargain, and the equity goes to the borrower or to satisfy junior creditors, reducing their risk. This also allows borrowers to increase their credit sources using their equity, promoting growth.

For example, in the case of a secured loan or a lease, the lender is entitled to all of the payments provided for in the agreement. However, the lender is not entitled to gain more than it expected under the contract simply because the borrower defaulted. To avoid this kind of unjust enrichment and to facilitate finance, the lender's priority extends only to the value expected under the contract when it is fully performed. (See C1c. above.)

Protecting the borrower's equity in the property also prevents manipulations to thwart the rights of subsequent unsecured creditors, such as tax departments or wage earners. A scheme could involve agreement to prefer payment to the lender while defaulting on tax obligations and payments of employees' salaries. This is then followed by the borrower's default on the loan. Subsequently, the lender seizes the property while maintaining the amounts already paid. This is unjust enrichment. The borrower has no further assets to pay unsecured claims while the lender made more than it expected under the contract. (See C1d. above.)

C2. Simplify Use of All Financial Devices

Many unreformed systems prescribe the form that secured transactions can take. In order to qualify, a contract between a secured creditor and a debtor must be in a specific form and must contain prescribed terminology. Specific actions are sometimes required, such as transferring ownership or possession of property to the borrower. Transactions that do not fit within these traditional formulations are not recognized.

A modern secured financing system is functional rather than formal. It avoids rigid formulations and specified contractual patterns. It allows a simple approach as part of any transactions that involve a grant of credit secured by an interest in property that can be enforced upon default. This approach eliminates the need to use technical legal language or traditional forms of agreement. It simplifies transactions, gives parties much greater freedom to tailor their contracts to their specific needs, and can accommodate new types of secured financing arrangements. Parties are free to use traditional language such as “pledge,” “mortgage,” “financial lease,” and “charge,” but these terms have no special legal significance other than to indicate that a security transaction and a security interest is involved.

A modern secured financing system facilitates a wide range of secured financing arrangements. Some examples follow; the first two scenarios involve the most common types of secured transactions involving SMEs.

C2a. Scenario 1: Secured Inventory Loan

A small business owner (SBO) who operates a retail business that sells and repairs small appliances has decided to expand his product line. The wholesale supplier of the new product line requires payment upon delivery of inventory to the SBO. However, the SBO generally grants 30 days’ credit to his customers.

The SBO approaches a bank and discusses the possibility of obtaining a secured loan to purchase the new product line. The bank considers many factors while deciding to grant the loan, including the SBO’s management record, his current debt load, the increased cash flow potential from sale of the new line, the existence of a resale market for the inventory, the potential value of the accounts receivable from inventory sales and repair services, prior security interests in the SBO’s other assets, and the efficiency and effectiveness of the enforcement system should the SBO default.

The SBO signs a security agreement under which the bank acquires a security interest in “all existing inventory, all future acquired inventory, all existing accounts receivable, and all future accounts receivable” of the SBO.

C2b. Scenario 2: Secured Equipment Purchase Loan or Leasing

A contractor, who operates a small unincorporated building construction business, requires capital to purchase replacement equipment. The contractor identifies an equipment supplier that has the equipment he needs. The contractor considered different sources for credit and concluded that, for his purposes, the optimum source is a secured loan from a bank. In making his decision, the contractor took into account the availability of alternative forms of financing such as leasing,

the amount of capital he required, the cost of borrowing, the ability to match repayment to future income streams, tax considerations, and the time it would take to arrange the financing. Though some of these factors favored leasing over secured financing, the contractor decided to seek a loan to purchase the equipment because the interest charges payable to the lender were considerably lower than the implicit interest charge in a lease. Furthermore, if the contractor misses a payment, the chance of peremptorily losing his "investment" in the equipment is less than it would be if he had chosen leasing.

The contractor approaches the bank and discusses obtaining a secured loan to acquire the equipment. The bank considers many factors while deciding to grant the loan, including the contractor's management record, his current debt load, the cash flow potential of his business, the expected rate of depreciation of the equipment he intends to purchase, the existence of a resale market for the used equipment, the value of his other existing equipment and of movable property he might acquire in the future (especially accounts generated from use of the equipment), prior security interests in his other assets, and the efficiency and effectiveness of the enforcement system.

The contractor signs a security agreement recognizing that the bank acquires a security interest in the equipment he purchased with the loan, on other equipment he now owns or acquires in the future, and on all accounts receivable.

C2c. Scenario 3: Conditional Sale (Sale with Installments)

A farmer who requires capital to purchase irrigation equipment for his small farm approaches Netafim, a producer and supplier of the type of equipment he needs. Netafim accepts installment payments. The sales contract provides that the seller (i.e., Netafim) "retains title and ownership" of the equipment until the purchase price is paid in full.

C2d. Scenario 4: Agricultural Credit Financing

A farmer who requires financing to purchase additional livestock asks a bank for a secured loan. The bank considers many factors while deciding to grant the loan, including the farmer's management record, the kind and quality of livestock he will purchase; his current debt load, the existence of a resale market for the livestock, and the efficiency and effectiveness of the enforcement system should he default.

The farmer signs a security agreement recognizing that the bank acquires a security interest in all the livestock he owns now or acquires in the future, including any offspring of the livestock and amounts received from the sale of any of the livestock.

C2e. Scenario 5: Warehouse Receipts: Specialized Financing Arrangement

A grain merchant who requires bridge financing to purchase grain to be on-sold in the immediate future asks a bank for a secured loan. The bank agrees to provide the loan on a secured basis. With the proceeds of the loan, the grain merchant buys grain and stores it in a commercial warehouse. In accordance with the terms of the loan agreement with the bank, the warehouse operator issues a negotiable warehouse receipt to the bank, the effect of which is to give the bank

complete control over the stored grain. By law, the transfer of the warehouse receipt gives the bank a security interest in the grain. When the grain merchant wishes to sell the stored grain, the bank will allow its release from the warehouse on the condition that either the grain merchant or the buyer pays the purchase price directly to the bank.

C3. Enforcement

Secured financing systems have little value in reducing lenders' risk of loss unless they can expeditiously enforce their rights in borrowers' property, at modest cost, through seizure and liquidation. In many jurisdictions, particularly those with civil law systems, enforcement of creditors' rights is possible only with court permission and involvement of state-run execution systems. However, particularly in developing countries, courts are too often overworked, and enforcement proceedings are delayed for very long periods during which the property deteriorates, is destroyed, or is disposed of by defaulting debtors. Furthermore, court proceedings involve significant costs that are paid either by defaulting debtors or, most often, by creditors. Court officials who have the authority to seize and sell property do not usually have the expertise or facilities to get a good value for the collateral they sell. Unlike creditors, they have little incentive to act expeditiously to avoid loss or depreciation of collateral. Finally, complicated auction procedures often discourage potential buyers from participating.

Modern secured financing systems include "self-help" enforcement mechanisms that permit lenders to seize and sell the property with no court order or official involvement. These mechanisms also include means to protect the public peace in of case one of the parties refuses to allow self-help enforcement at the moment of seizure. Finally, enforcement mechanisms also protect debtors from abuse by creditors, including fraudulent or improvident sales of the collateral (Baranes & Cuming, 2001, p. 8).

D. Main Steps for Developing Modern Secured Financing Systems

What follows are the main steps to plan and implement a modern secured financing system, including the pre-reform diagnostic study and the three main reform components: legal reform, institutional reform, and building local capacity.

D1. Diagnostic Phase

Undertaking a thorough diagnostic as the first step in a full-fledged secured financing reform has several advantages. First, it allows reformers to consider existing practices and prevailing conditions during the design of the reform itself. For example, in some jurisdictions, banking regulations consider loans secured with movable property as sub-standard loans and require that banks provide reserves against loss as if the loans were unsecured. Depending on the state of the law, this may not be justified.

Second, the diagnostic informs the allocations of resources among the three main components of the reform. For example, in jurisdictions with complex legal systems involving several levels of government, the legal reform and the registry reform may last longer. In other cases, where financial institutions use almost no secured financing or enforcement officers have no capacity,

policy, or practice of timely and efficiently enforcing creditors' rights, more effort may be required for the third component of the reform (i.e., building local capacity).

Third, the diagnostic allows reformers to tailor essential features to local custom and practice. For example, in jurisdictions with civil law traditions, the concept of notice registration may be more difficult to implement then in common law-based jurisdictions. Jurisdictions with constitutions that provide for subnational governments with subnational-level legal and registry systems may benefit from computer technology which allows creation of multiple registries that communicate with each other, thereby maintaining the real-time information.

Finally, the diagnostic allows for collection of pre-reform baseline data for impact evaluation and assessment of reform. In some jurisdictions, statistical data about the number of secured loans and registration were collected periodically before and after the creation of the registry.

Because the diagnostic phase sets up the framework for the reform, it is common to include a comprehensive report before the project is designed. Usually, a report will include an overview on collected data related to credit practices and a snapshot of existing legal and institutional systems pertinent to secured financing. The BizCLIR Credit Access indicators are a valuable tool to assess many aspects of existing systems of secured financing and the approach necessary for reform. However, it should not be used as an exclusive template to design the reform. For this, the IFC guide, *Secured Transactions Systems and Collateral Registries,* should also be used.

D1a. Collect Baseline Data

The following data can be collected from interviews, reports from central banks and statistical agencies, and written material from international financial institutions and donor organizations:

- Volume of lending disaggregated by secured and unsecured
- Secured lending disaggregated by movable and immovable property
- Total number of pledges of movable property on file and monthly volume of entries
- How many types of financial institutions currently grant secured or unsecured credit and for which types of transactions
- The characteristics of businesses and individuals that are able to obtain credit from commercial sources
- The types of property acceptable to secure credit
- The level of secured credit, terms, and interest rates
- How interested the private and public sectors are in having a modern secured financing system
- Cultural or social factors that would interfere with the implementation and functioning of the core requirements of modern secured financing systems, including cultural norms and public attitudes that must be reflected in secured financing systems
- Any existing, planned, or possibly related reform by national or international agencies

D1b. Assess the Legal and Institutional Framework

The preliminary study should examine and assess the legal and institutional framework within which secured financing occurs. This may include:

- The range of secured financing transactions covered under existing law and the ease of establishing them
- The priority structure within which they operate
- The existence, efficacy, and use of all existing registry systems for claims arising under those transactions
- The role and efficiency of courts and court-administered execution agencies in enforcement of secured financing contracts that are in default
- The enforcement mechanisms and structures applicable to them
- The interface between existing secured transactions law and related laws governing contracts, sale of goods, leasing, bankruptcy and insolvency, and enforcement

D1c. Recommendations

A diagnostic report should include recommendations for concrete steps to carry out the reform; the recommendations should target the three main components of the reform. In some cases, this can include an action plan, including a timeline and budget for the projected resources necessary for reform.

A diagnostic report may also include specific recommendations for a particular jurisdiction. For example, in some jurisdictions, secured financing laws and registries could be extended to cover mortgages on real property with minimal additional effort. Alternative dispute resolution mechanisms are another example; in some jurisdictions, out-of-court dispute resolution procedures are implemented through legal provisions in the secured financing law. Finally, in some jurisdictions, developing private enforcement agencies could be a feasible option to shorten the process of enforcement.

D2. Legal Reform: The Basis for Successful, Sustainable Development

D2a. Objective

The objective of legal reform is to enact the essential features of a modern, efficient secured financing system that embodies international best practices and, as much as possible, interfaces with existing law and structures, and addresses the social and cultural norms of the country. Below are the main steps that can lead to such a result.

D2b. Establish a Relationship with the Relevant Government Agency

Successful reform will depend heavily on the availability of support from local stakeholders in the private sector and, particularly, the public sector. The law reform is more likely to succeed if the government department or agency responsible for legal and commercial policy has sufficient influence in the political structure to effectively sponsor modernization of the secured financing legal regime and can be relied upon as a local counterpart. The diagnostic report may provide valuable information in identifying such an agency.

D2c. Determine Policy Considerations

Before legal drafting begins, it is necessary to establish the policies the proposed reform will promote. This can be done in consultation with government officials responsible for the policies

on which a new secured financing law would be structured. The most important example involves priorities among conflicting claims. Do secured creditors always win everything they are owed? Or, do some social claims — tax claims, for example — receive higher priority? Should some unsecured creditors get a higher priority than others? For example, trade creditors or workers' wages? In some jurisdictions, protecting some types of unsecured creditors may be an important local policy; in others, increasing access to finance may dictate stronger protection for the rights of secured creditors. The role of the priority rules is to reflect these policies in a balanced way that allows parties to manage risk and proceed with certainty.

D2d. Drafting the Proposed Law

Drafting a modern secured financing law that preserves essential global principles (and is in harmony with the overall existing legal system) is a complex task. It requires familiarly with the essential features of modern systems, local policy considerations, and existing legislation. Drafting of the legal provisions requires expertise in legal drafting in general and commercial legislation in particular.

Generally, jurisdictions without an established, modern secured financing practice do not have the domestic expertise required to develop a draft law. In such cases, international assistance and expertise are both essential. The drafting process can play an important role in developing host-country capacity, with international experts working on the ground with local lawyers and public legal officers, directed by established international standards and practices. Two sources are UNCITRAL's *Legislative Guide on Secured Transactions* and the IFC's *Secured Transactions Systems and Collateral Registries*. A more general overview of the main components of a modern legal system can be found in the European Bank for Reconstruction and Development's *Core Principles for a Secured Transactions Law*.

Working and drafting groups may be of assistance in some jurisdictions. A well-composed working group will include a large number of stakeholders to assist in establishing the policies the new law will advance. It will also provide technical expertise regarding features of modern secured financing law that conflict with existing legislation. However, a much smaller group of experts should undertake the delicate work of drafting provisions that reflect policy choices and tailor the new regime to fit comfortably within the existing legal framework. Any proposed draft should be reviewed and revised by the larger working group before advancing to the legislative process.

A complete legal reform will address the following areas:

- *The scope of the law's applicability* must be broadly defined to cover all transactions that pose serious risks in dealing with movable property.

- *Introduce a simple new procedure* that allows lenders and borrowers to create a secured credit arrangement to replace requirements for mandatory forms and formalities (e.g., the use of notaries or legal advisors).

- *Priority rules* determine what potentially conflicting claims win, based on date of publication and the preferred policy considerations identified by the working group.

- *Require the publication* of notice of claims in movable property and delineate the procedural steps to provide public notice. The law should require that registration is the only method to achieve publication, and that possession establishes priority only when registration is not possible (e.g., in the case of negotiable instruments such as warehouse receipts).

- *Enforcement rules* must provide a complete, effective set of procedures for enforcing security interests. This should include a self-help, out-of-court mechanism for seizure and disposition of the property when the parties agree. The law should not require pre-seizure warning notices to those whose property is about to be seized.

- *Transition provisions* govern how the country and its borrowers and lenders move from the old regime to the new one. The transitional period must allow old registrations to be included in the new databases. The transition period should not affect the process of registrations of new claims.

- *Reforms to related legislation* are necessary to avoid conflicts in the law and provide a consistent platform for secured financing that accommodates the new features in the reform. Related legislation may include laws governing leasing, liens, insolvency and bankruptcy, enforcement, tax, labor, and property.

D2f. Continued Expert Support throughout the Legislative Process

Law reform does not end with the introduction of proposed legal reform to the local government. To a large extent, the reform's success depends on the legislative process. Sound draft laws can be mangled by amendments made during debates in government or parliament. Amendments to proposed drafts should be monitored throughout the legislative process, and reformers, including the government agency championing the process and technical advisors, should be continuously available.

D3. Registry: Main Considerations in Design and Implementation

This section addresses key design issues that often surface during reforms and provides best practice recommendations. It does not provide the full range of activities and considerations for creating modern secured financing registries because those are beyond the scope of this FS Series. They are, however, discussed in detail in the IFC's *Secured Transactions Systems and Collateral Registries Guide* and the Asian Development Bank's *Guide to Movables Registries*. The features mentioned below are what determine whether the new regime will be effective, providing the least risk and the lowest costs to maintain over the long term.
A paperless, Web-based registry is always possible and always the best option. Designing and implementing a modern computerized registry is often not as complicated as it may seem. Though the most current computer technology and communication facilities are not always available throughout every jurisdiction, some form of Internet technology is realistically

available in almost any jurisdiction. As long as the registry system can be hosted online and people can access it through the Internet, other types of submissions (e.g., faxes and paper-based submissions) should be prohibited. The fact that some people in some places do not have Internet access is not a sound basis for deciding that a registry should not be fully electronic. In such cases, people can access the Internet via service providers. This will not compromise the efficiencies of an electronic registry, the advantages of which outstrip the benefits of ensuring that all people have access. This is particularly true in developing economies, where registry institutions struggle with the management of paper-based archives.

Regulations can often compensate for gaps in the legal system. Regulations usually deal with the operation and administration of the registry, including the process of creating, amending, and deleting a registration; conducting queries of the registry database; other services provided by the registry; and, in some cases, the fees for such services. However, regulations in many cases can play an important role in completing the law reform. Regulatory provisions can be drafted to cover some deficiencies in the legislation or fill in gaps. This may include the parts of the law that deal with establishing the registry and the prerequisites for valid registration and search, including legal requirements. For example, a regulatory provision can stipulate that 'a registration is valid for priority purposes if it can be retrieved by a search based on the identifier of the debtor.'

A registration's validity is usually regulated by the law, but it may be included in regulations if it is omitted from legislation. Without a provision in legislation or regulations, serious confusion may arise regarding search results and priority conflicts. The sample provision above ensures that people who rely on registry information are protected in every case. The rule it provides governs failures of the registry system to disclose information that was properly recorded and data-entry errors made by the registrant.

A centralized database is always possible. Decentralization of registries is often advocated in federal jurisdictions comprising federal and subnational governments. In many cases, the registry's operation can be decentralized without splitting the database. A constitutional structure in which sub-national jurisdictions control the recording of transactions that originate within their own territory can be achieved by employing IT methods that also maintain the integrity of the centralized database.

A centralized database is always more effective. A centralized database of secured transactions has several advantages over distributing the same information among several databases. Most importantly, it reduces costs and risks to lenders who have to search only one place and register in only one place. Other advantages include:

- It allows retrieval of complete information in real-time, without the need to synchronize information from several databases.
- It reduces the risk of registry malfunctions resulting from communication failures among databases.
- It reduces design, hardware, software, and maintenance costs.
- It requires fewer technology staff.
- It facilitates fast and easy system enhancements/upgrades.
- Security and backup procedures are easier to implement.

Set registration fees to cover transaction costs. Fees for registry services have two purposes. First, they should generate income sufficient to cover operation costs. Second, they should discourage non-commercial use of registry services. The fees for each registration and search should cover the actual cost of processing each transaction. Registration fees should be based on the amount of data, the lifetime of the registration, and related expenses; they should not be based on the amount of a loan or on the value of the collateral.

Identification of registry hosting agency. The type and quality of the agency responsible for operating a registry is important. Registry operation may involve either a government agency or a semi-autonomous government body. The selection of the most suitable entity should rely primarily on criteria such as being able to provide a secure and climate-controlled location and a staff of experienced IT professionals and operators. Outsourcing of existing registry services to a semi-autonomous government body or NGO should usually not result in increased fees; it should never include transfer of ownership of the database.

Produce user guides and registry operation materials, and establish a help desk. Guides for registry users play an important role, especially in implementing a new system. Guides shorten the time it takes staff to learn how to operate the registry and begin to work independently. Guides also help outside users and service providers to learn how to interact with the registry and use its services. Establishing a help desk is important because users will need support. However, requests for advice and information can create risk, so help desk staff (i.e., the registrars) must be able to fully answer questions about how to use systems and carry out processes. They should never give legal advice. In some jurisdictions, help desk information can be provided only electronically to reduce the risk of accidentally giving legal advice. Guides for outside users can further reduce the likelihood of the registry's legal liability because they reduce users' need to rely too heavily on help desk services.

Provide a transition period for data migration. One common mistake while developing a new registry is to start operations before it has been updated with previous registrations. This may create risk for new lenders or result in the loss of old, valid claims. If there is not a grace period for re-registrations of old data, those registrations may unjustly lose priority to conflicting new registrations. The solution is a transitional period with priority rules related to old registrations.

A grace period should be given for re-registration of old data as condition for maintaining existing priority. Registry staff can handle data migration, the system can be designed to automatically re-enter old data into the new database, or the parties who registered the claims can be responsible for re-entering them.

Launching of the registry. The registry should be officially launched before or at the same time the law comes into force, but only after the entire computerized system is in place, fully tested, and ready for operation. Each of these components is important because it ensures proper operation of the registry with the law.

D4. Building Local Capacity

A modern secured financing system involving movable property will not increase access to credit unless it is used, particularly in jurisdictions where movables are not traditionally used as

security for credit or are regarded as risky to rely on as security. Measures designed to educate potential users can advocate for — and increase — the use of movable property as collateral, thus expanding access to credit. The following are the target groups for a local capacity-building program. This section should also be read in conjunction with the IFC's *Secured Transactions Systems and Collateral Registries*.

Lenders. The extent to which lenders rely on a new secured financing system will determine its degree of success. Modern secured financing requires that lenders adopt practices different from those they use for unsecured loans or loans secured by immovable property. In particular, successful implementation of modern secured transactions law requires that lenders build their capacity in the following areas:

- Ensure the debtor owns or can reasonably be expected to acquire ownership of the property described in the agreement.
- Determine the extent (if any) of priorities of existing secured and unsecured claims. These might include secured loans, financial leasing, unpaid taxes, social levies, and unpaid wages to the debtor's employees.
- Determine whether there is a market for the property during the period of the loan should it becomes necessary to have it seized and sold.
- Require that the property be fully insured.
- Take measures to ensure that the property is not handled or used by the debtor in such a way as to cause accelerated depreciation.
- Take measures to ensure that the collateral (other than inventory) is not sold by the debtor to someone who takes it out of the jurisdiction or otherwise makes seizure difficult or impossible.
- Where the collateral is accounts, establish an assessment and valuation system under which the debtor's books are periodically examined to identify uncollectable accounts and ensure maintenance of the appropriate ratio of collectable accounts to amount of loan outstanding.
- Register a claim in the electronic registry.

Legal community. The legal community is composed primarily of lawyers, judges, and notaries. When members of the legal community understand how to apply their new secured financing system, implementation is more likely to be effective in the medium and long terms. Financial institutions may wish to consult lawyers or notaries when drafting contracts for standard use. This can happen in the context of complex secured transactions that involve small, medium, or large sums of money. It is also important to ensure that members of the judiciary who are called upon to apply the provisions of the new legal system are trained thoroughly in the use of the new concepts and operational features. Training of trainers can take place in jurisdictions where professional organizations can sponsor training events. These umbrella organizations, such as law societies or banking and business associations, can ensure training continues long after the system begins operating.

Enforcement officers. Perhaps the most important group is enforcement officers. Secured financing reform programs do not always include a component to train enforcement agencies. As a result, enforcement is often ineffective, despite having a modern law and registry in place.

Enforcement officers should learn how to comply with expedited enforcement mechanisms and new procedures. In particular, they should be familiar with new provisions dictating time limits for seizure of property, eliminating requirements for giving the debtor advanced notice of seizure, and, if applicable, allowing the creditor to dispose of the property on its own. Though often exasperatingly inefficient, streamlining and automation of enforcement agency business processes can be as important as training.

Registry staff. As mentioned earlier, registry staff must be fully prepared for the moment when the new system begins operations. In some jurisdictions, ending staff involvement in the registration and searches process can be challenging; switching to an online help service from a phone-based system can also take time for adjustment. Training should tell registry staff how their roles will change, especially when they will no longer be responsible for certain tasks (e.g., registrations). It should also include administrative issues faced by the agency responsible for the registry, including financial and statistical reporting, and the new IT roles involved in running and maintaining a Web-based registry.

Academic institutions. Though short-term training is an effective way to introduce the business and legal communities to the new environment, long-term education is more effective for establishing the new system as a means to create financial products that enhance access to credit. Students who will become lawyers, judges, and businesspeople are more likely to be receptive to new concepts than professionals who were educated or trained in the old systems. Law schools and business schools can integrate courses on modern secured financing into their curricula. When such courses are not practical, secured financing may be combined with courses dealing with commercial, civil, or business law.

Public awareness. There is no evidence that public awareness about secured financing contributes much to the long-term success of reforms. In some jurisdictions, public awareness was raised simply through the regular operation of financial institutions after the system began operations. A public awareness campaign that is too aggressive or not properly structured may cause unjustified feelings of risk among some citizens. In many developed economies, the public is not even aware that a secured financing system exists. This said, the likelihood of conflicting claims arising in developing economies is even smaller than in developed economies. Consequently, allocating any significant resources for public awareness activities is not recommended.

E. Case Studies

The case studies that follow provide practical examples and lessons learned about how best to implement secured financing reform and increase access to credit. Two main cases are discussed - a USAID project in BiH and a Rwanda government project that was supported by a number of international donors. Brief studies follow of five cases that illustrate specific aspects of reform content or process. With the exception of the Guatemala case study, the author of this FS Series, Yair Baranes, participated in all the projects described.

E1. BiH: Getting it Right

The objective of the USAID Pledge Registry Project, which started in 2002, was to reform BiH's secured financing system. The project's three components — legal reform, registry reform, and

building local capacity — were aimed at removing the barriers that existed to financing based on movable property as security.

BiH is a federation comprising a national government with three subnational entities: the Federation of Bosnia and Herzegovina, the Republic of Srpska, and Brcko, a much smaller district. The BiH constitution divides legislative powers among the national government and its three subnational entities. Property rights, including those that arise out of secured transactions, fall under subnational jurisdiction. As a result, each of the sub-national governments has the authority to create a separate law and a separate registry system.

Prior to project start, the BiH secured financing legal system was deficient for several reasons. First, the country's legal tradition in commercial law did not recognize modern concepts of secured financing law. For example, the use of future property as security for credit and modern priorities schemes were foreign to the legal system. Second, an earlier reform resulted in three separate pieces of legislation, one for each sub-national unit. None of the BiH entities had a modern registry, despite that each had laws requiring them.

The old-style registration systems were not computerized; mortgages and pledges were recorded manually in "registrations books" located at local court houses. The registration procedure was lengthy and often resulted in errors. Mortgages and pledges were deleted by hand — by crossing the record out with red ink.

Furthermore, people seldom used movable property to secure credit. Credit was limited because real estate was the primary security; it was available only to those with undisputed title to land.

E1a. Results

Law reform. Several aspects of BiH's legal system were reformed. The most challenging part of the reform was to create unified secured financing legislation for the whole country. This required an exception to the constitutional division of power provisions. Moreover, a unified legal system would necessarily require revocation of the earlier laws enacted with the support of the international community, essentially reversing earlier reforms. Finally, the proposed secured financing regime had to accommodate BiH's civil law tradition without sacrificing its efficacy. The BiH political environment was not conducive for this kind of reform. Opposition to the unification of public institutions at the national level was high, and reversing an earlier reform supported by the international community added to the hostile environment. Secured financing reform also required interaction with other uncoordinated initiatives, such as bankruptcy reform and financial leasing, which were taking conflicting approaches.

The project conducted a detailed drafting exercise with local stakeholders and six months of work with BiH parliamentary committees and members during the legislative process. Then, in October 2005, the national parliament of BiH passed new national secured financing legislation, the *BiH Framework Pledge Law*. This law contains all elements of a modern secured financing system tailored to local practice and the BiH legal environment. Representatives throughout BiH supported it, and financial institutions looked forward to secured financing transactions.

Registry reform. The new BiH legislation provided that the law would take effect only after creation of a modern, centralized secured financing registry and a transition period for stakeholders to learn the new system and transfer claims registered under the old system. It opened the door for a single, electronic, Web-based system that users could access from anywhere in the country. The law also provided for adoption of regulations to govern operation of the registry, including setting service fees.

The modern, Web-based registry has been operating for almost five years, and users report complete satisfaction. Registration and searches are done online, and fees are deducted from prepaid user accounts. Registry officials are not involved in the registration process or searches. The system automatically generates confirmations of new registrations and search results, which are provided instantly online. Financial institutions have requested that the government examine expanding the pledge registry to include mortgage registrations. People without an Internet connection or computer skills can get access from private providers for a nominal fee. The fees the registry collects (e.g., for registering and searching) help pay for system maintenance and upgrades. The registry is fully electronic and paperless, and relies on secured digital archives only. The pledge registry has one employee.

Increased local capacity. The new pledge registry system was scheduled to be completed six months before the law went into effect to allow time to train financial institutions in the legal system and operating the registry. Stakeholders used a simulated registry system during training, and the program gave support to academic institutions. By the end of a three-month training period and three months before the law and registry went into effect, all financial institutions, including their legal and credit departments, reported they were ready to use the registry. Each institution had at least two employees trained as trainers. Consequently, during the transition period, each was able to re-register its old claims, to maintain priorities; none reported errors. Today, all financial institutions, including banks, leasing companies, micro-credit organizations, rely regularly on the registry services. Local capacity has also increased among other stakeholders, including the judiciary, enforcement agencies, private and public lawyers, and the public.

E1b. Lessons Learned

1. *Secured financing reform is the "traffic controller" for all secured transactions.* To the extent possible, modern secured financing law should centralize priority provisions for all financial transactions that rely on movable property in a single legislative regime. This simplifies risk assessments and creates a springboard for development and expansion of all secured financing devices, including secured loans and financial leasing. It also allows all financial-sector vehicles to develop and operate in harmony, and prevents collusive arrangements to defeat some public and private claims.

2. *Coordination among international donor activities is critical.* Growing international recognition of the critical role access to credit plays in economic growth has led to the proliferation of financial-sector reform initiatives. However, these often conflict with each other. The most common example is the conflict between financial leasing reform and secured transactions reform, with each implementer trying to enhance the position of its vehicle at the expense of or without considering the importance of the other. Ideally, a

reform will include both areas. Effective coordination among reform activities related to secured finance can also produce the desired results.

3. *A sustained three-year effort is the average time required to create a successful secured financing regime.* Successful reform — that yields a modern secured financing system that demonstrably increases the use of asset-based finance to enlarge domestic credit — requires a sustained, strategic campaign that moves through the stages described above and roots the new regime in the local commercial culture. Providing sustained resources over a sufficient period is even more important than the total amount of allocated financial resources. The BiH experience illustrates the importance of providing technical expertise during the legislative process. International expertise is essential during this period. How it is applied (e.g., meeting directly with lawmakers or providing review and comment about proposed amendments) depends upon the prevailing political environment. Similarly, the new regime will take root more quickly if project experts continue to assist during the initial phases of registry operation.

4. *A fully electronic, Web-based registry is always the best solution.* Large areas of BiH do not have access to Internet facilities. Furthermore, many farmers, pensioners, and small businesses cannot or do not want to use computer technology. These factors, common in developing countries, often give rise to calls for paper-based transactions. Paper-based applications for registrations and searches require officials to enter data and create and maintain archives that hinder efficiency. BiH authorities resisted the temptation to sacrifice the efficiency of a fully electronic system to meet needs that could be met more effectively in other ways. Committed to electronic-only submissions, they relied on private-sector service providers to meet the needs of those without the technological means to directly access the registry. These providers are easily accessible throughout BiH; they function as intermediaries, allowing all citizens to access the registry database electronically.

5. *Modern secured financing systems are suitable for common law and civil law jurisdictions.* BiH is a civil law jurisdiction. USAID's success there proved that secured financing systems can function effectively within any legal environment. Practical solutions that provide reliable information and make commercial transactions less risky and more predictable — a requirement common to all jurisdictions that employ free market economies — can be developed for any legal system.

6. *Secured financing systems are naturally national and unified.* Unlike immovable property, movables change their location and may travel across jurisdictional boundaries. Modern secured transactions and foreign investment involve cross-border financing and often, international financing. Maintaining multiple legal and registry systems multiplies cost and risk, and requires intense coordination efforts among initiatives in different jurisdictions to achieve consistent future reform. To avoid these complications, reform initiatives that deal with movable property should be on the national level. The BiH experience shows that with the proper lobbying strategy and project design, even the most difficult separatist jurisdictions can come together to achieve national, unified secured financing reforms involving movable property.

7. *Creative legal drafting techniques can overcome resistance to law reform.* Though sometimes complex, the concepts and rules of modern secured financing law are important for effective operation of the law. Legal concepts that are perceived as foreign and complex can generate political objection. In fact, these core principles can be easily infused into an existing legal system by changing their appearance or form. Creative drafting techniques can address the specific concerns expressed by legal experts within a given jurisdiction, while maintaining the effectiveness and clarity of the law in general.

8. *Showing the light at the end of the tunnel — the registry*. Secured financing registries are often perceived as complicated to design and operate, and expensive to produce and maintain. In fact, the opposite is true. The database systems are relatively easy to create with the proper specifications that reflect the legal system requirements. The simplicity of using modern secured financing registries can be illustrated at the outset of a project by demonstrating registration and search functions on existing systems to generate support for the reform.

9. *Effective training can reach more with less.* The swift uptake and now widespread use of the secured financing system among all financial institutions and lawyers in BiH was a result of an effective training and awareness program. The use of IT and innovative training methods can change the commercial behaviors of relevant stakeholders. Online materials provide long-term educational opportunities for private and public institutions. Professional capacity can be increased in the long term through programs in academic institutions and including secured financing topics in curricula at law schools and business schools.

E2. Rwanda: Who's on First?

The introduction of secured financing reform in Rwanda was a product of the international community's policy of increasing access to development finance in Africa. In commercial terms, Rwanda's financial sector did not use movable property as collateral and lending suffered. Although micro-credit organizations provided small secured loans to consumers in remote locations, banks and other financial institutions used land as security for credit or provided unsecured credit to preferred customers. Without a modern secured financing law and registry in place, movable property was not regarded as sufficient to secure credit.

Recognizing that movable property in Rwanda was "dead capital," the international community aid assistance package included a program designed to use movable property to increase access to finance. The mechanism chosen to finance the program was direct financial assistance to the Rwandan government. The government agency that runs the registry, the Rwanda Development Board, was to manage the use of the funds in selecting the most appropriate and cost-effective reform for the country. The enthusiasm to engage in the reform was fueled by Rwanda's wish to improve its rankings on the annual World Bank *Doing Business* report.

Rwandan secured financing law began with collaboration with the international community. A draft law was prepared and circulated among local and international experts provided by the international community. Collaboration on the legal reform stopped abruptly once the proposed draft entered the legislative process. Local expertise in the government and parliament was not

sufficient to assure that key concepts of a modern secured financing system survived the legislative process intact.

In addition to the secured financing initiative, a financial leasing reform was underway. This reform aimed at increasing financial leasing activity and was part of a larger effort implemented in other African countries (IFC, 2009). By the time the secured financing reform started, a proposed draft leasing law was already going through the legislative procedure. The proposed leasing law included provisions giving lessors priority over third parties, even without publishing notice of their claims. It also included provisions allowing lessors, "upon default," to repossess "their" property from lessees without accounting for any equity created by the lessee. This triumph of form over substance creates risk. Buyers and lenders cannot discover the lessor's superior interest. Ironically, though, lessors' risk is also made worse by making it easier for lessees to sell unregistered property. The proposed draft financial leasing law was, therefore, in direct contradiction to modern secured financing best practice and the declared policy of increasing access to finance.

The registry system was developed without real consideration of expert advice provided by the international community. The contract between the government agency and the contractor building the registry produced a close and tense relationship. International assistance and recommendations were regarded as non-binding, third-party intervention, and were largely ignored. The inspection of the registry reform, its business logic, its IT, and quality control of contractual deliverables were left almost exclusively in the hands of Rwandan authorities who lacked the expertise required to perform these tasks.

E2a. Results

The results may not live up to the expectations. The desire of Rwandan authorities to grow the country's financial system was stunted by legal and registry systems that contravened basic best practice and failed to create a secure, efficient lending environment. Design results were poor despite plentiful Rwandan and international spending. The new system launched recently; it will be interesting to monitor its impact.

The new Rwandan legislation has significant deficiencies. By the end of the legislative procedure, several central concepts of modern secured financing systems had been omitted. For example, by deleting the special priority provisions for credit secured by the assets the loan was used to purchase (i.e., PMSI), the new legislation effectively allows one creditor to monopolize its debtor's credit sources. If there is not a PMSI provision, this happens when a lender takes a security interest in all of the borrower's existing and future property, placing the borrower at the mercy of a single creditor for all financial needs. The mechanisms designed to avoid this situation in the original draft were deleted during the legislative process. This monopoly situation is likely to reduce competition among credit providers, which will lead to higher interest rates and worse conditions on other loan terms, such as length and the amount of credit.

Rwanda's draft leasing law creates further risk to those dealing with movable property. The provisions that grant the financial lessor priority with no need to provide notice to third parties make other commercial transactions (e.g., sale of goods and credit secured by movable property) very risky. With provisions that do not recognize the existence of the lessee's equity, more

capital invested in creating this equity "dies." It is likely that as more financial leasing transactions are created in the Rwandan market, the risk of dealing with movable property will increase and more development capital will be lost.

The new Rwandan secured financing registry does not include some of the central features recommended by the international community. First, registrations are not notice-based. As a result, modern Internet technology cannot be fully used for completing the registration procedure; the security agreement must be submitted to the registry before the registration is approved. Second, the registry is legally liable for the accuracy of recorded information because its registrars enter the information after approving the registration. Third, people must go to the registry in person to submit required information and pay registration fees. Fourth, public disclosure of information includes unnecessary details about the credit arrangements.

Financial institutions are not likely to rely on the new Rwandan secured financing system to make credit decisions, particularly in the short term, because there have been no training or local capacity-building activities. The financial community is not familiar with the central features of the law, such as how to describe property in credit contracts and registrations. The new priority rules are incomplete in the legislation which may confuse credit officers conducting risk assessments. Finally, there is practically no capacity among local reformers to engage in further reform to redress the deficiencies of the new system.

E2b. Lessons Learned

1. *International and local expertise should be available throughout the legal reform.* Rwanda's experience highlights the importance of making international expertise available during the drafting of the proposed legal reform and during the legislative process. The process of accommodating policy considerations and drafting the proposed legal system is an opportunity to build local capacity by involving public and private stakeholders. But international expertise should continue to be available during the legislative process to address government or parliamentary inquiries, and review and comment on all drafts. This will avoid irreversible drafting errors or omissions and amendments that will reduce the effectiveness of the reform.

2. *Lack of contractor accountability to international donors can jeopardize the quality of reform.* Expert support from the international donor should be available throughout the reform process — and not merely for the purpose of making non-binding recommendations. Evaluation, selection of a proposed reform, and monitoring of implementation should be done jointly by local counterparts and the donor organization. Based on results, USAID's approach, which relies on a direct contractual agreement between the donor and implementer, is the preferable model. This makes the quality and cost of proposed reforms subject to evaluation by experienced experts; deliverables are subject to scrutiny and approval by the international donor and the local beneficiary.

3. *Reference to certain international standards and guidance is essential for high-quality reform.* The international literature provides a good overview of the design and implementation of best-practice secured financing systems. The quality of reforms can be assessed based on the guidelines these resources provide. A project that follows these

international guidelines, with modifications for the local context, has a greater chance of success. This FS Series discusses some of these resources.

4. *The World Bank* Doing Business *report provides a good incentive for modern secured financing reform.* The annual ranking of countries on the World Bank *Doing Business* report is an effective tool in generating interest among local public stakeholders to engage in secured financing reform. However, this interest should be translated into a careful and methodical reform program implemented to maximize its effectiveness, rather than meeting minimum scoring criteria (Channell, 2006, p. 2).

5. *Credit becomes more risky if financial leasing reform and secured financing reform are not coordinated.* Modern secured financing policies are the conceptual basis and starting point for the introduction of financial leasing. Financial leasing laws should deal with only the legal relationship among the parties to the leasing agreement, not with the rights of third parties. Furthermore, they should recognize the equity acquired by the lessee during the lease. Finally, priorities between lessors and third parties are part of the larger scheme of priority rules, which is addressed more effectively by comprehensive secured financing laws.

6. *Computer automation of bad practice is not modern secured financing reform.* The introduction of computer technology into public institutions can help modernize them. However, modernization cannot occur without a reform involving the upgrading of business processes. Using computers to automate bad practice reduces impact and may result in the need to reform the reform. Because local capacity and financial recourses are not always available or sufficient for further reform, additional international intervention may be needed.

7. *Building effective local capacity must precede the beginning of system operation.* Building local capacity is often referred to as the "third pillar" of secured financing reform. Local capacity is important throughout the reform. However, it is more critical for it to be in place when the system is effective by law. Training opportunities and awareness activities should be built into early stages of the reform and continue throughout the life of the project.

E3. Kosovo: Copy-Paste Can Make It Worse

In 2000, United Nations Interim Administration Mission in Kosovo (the temporary government in Kosovo), with the assistance of the international community, initiated reform of the country's secured financing system. Because of Kosovo's and Albania's common ethnic and cultural background, the Albanian system was chosen as the model for reform. Although the legal and registry systems have been working relatively well since their inception, the international community and the Kosovo government recently decided to re-reform the system because some of the features of the Albanian legal and registry system were not suitable.

The most obvious example is the indexing of registrations. When Albanian authorities began their secured financing reform in 1999, Albanian citizens did not have a unique government-issued identification number. Therefore, registrations were indexed by first name, father's name,

and last name. The reform in Kosovo adopted this system — failing to recognize that every citizen had a unique identification number that could be used as indexing criteria for registrations. The result was a more complex, less reliable system.

E3a. Lessons Learned

1. *Best practices are not universal.* Best practices are just that when they can be adjusted based on specific local conditions. Often a practice that is best for one jurisdiction will not suit another. Therefore, best practices should be used as background and a starting point, and should be modified to reflect local conditions.

2. *Selection of simple registrations and search criteria is essential.* Where applicable, reforms should use unique government-issued identification numbers as the indexing criteria for registrations and searches. Names of individuals or companies are not as efficient.

E4. Albania: Privatization of the Registry … and Its Fees!

In 2009, the Albanian Registry of Securing Charges transferred operation of the registry services to a private local company. The Albanian government remained in charge of the institution, including setting the fees for the registry's services. It retained ownership of the database and the institution while it freed itself from the burden of running the registry, of maintaining and improving its services, and from the legal liability for errors or omissions by registry staff or the registry information system.

An important aspect of the original reform in Albania was the use of income generated from the fees for using registry services. The local authorities designed the legal and registry systems with an eye to long-term operation. Fees charged for registry services were kept low and the revenues they generated went to the government budget. Sufficient sources were directed to improving registry services. Following privatization, registry fees increased and most of the revenue went to the private operator. Furthermore, in March 2010, the government passed a decree requiring searches of the now-private registry before certain credit and sale transactions involving movables could take place. This decree contradicts the spirit of the law and some priority provisions of the law. It infuses a new element of risk in dealing with movable property and unnecessarily increases the income the private registry generates from public funds.

E4a. Lessons Learned

1. *A reform project should consider the long-term operation of the registry institution.* In some jurisdictions, outsourcing of registry services may increase the likelihood of long-term success. The law should accommodate the possibility of partial privatization of registry operation.

2. *Secured financing registries can never be fully privatized.* Ownership of the database and control of the types of services and their costs must remain with the government; this guarantees property rights, much like land registries. Other administrative tasks and liability for mistakes or misuse of information can be outsourced. Privatization of the

income generated by the registry can result in undue influence on governments to raise fees and private and public spending to increase the registry's profitability.

3. *Set registry fees based on transaction costs.* Fees for registry services should be based on transaction costs. Income from fees should be used to develop existing and new services, not to increase net profit.

E5. Guatemala: One Size Fits No One at All

In 2008, the Guatemalan government, with the support of the international community, enacted secured financing legislation based on the OAS model law. The reform attempted to emulate the model legislation, for the most part using it as a "cookie cutter" to stamp out the new law.

The OAS model law was developed in an attempt to provide a general platform for secured financing system reform. As a result, it does not include some important provisions that are meant to be developed by the implementers of each specific reform. One of the most important provisions in modern secured financing legislation coordinates the timing of when the legislation takes effect with the start of registry operations. It does not make sense to introduce secured financing legislation with priority rules based on registration when a registry does not yet exist. The OAS model secured financing law does not include such a provision, leaving it to individual countries to adopt a suitable provision.

The Guatemalan reform program failed to include a provision postponing the effective date of the new secured financing law until after the registry was established. As a result, Guatemala had a law in force with no registry and consequently, no way to resolve conflicts over property rights that were supposed to be resolved based on registration. Later, a provisional registry was introduced in an attempt to address the problem, but it had a cumbersome registration procedure that involved a complicated fee structure based on the value of the loan. A second round of reform to establish a new registry was planned to take place in 2010.

E5a. Lessons Learned

1. *Model laws are not a "cookie-cutter" solution.* Available model laws and, to a lesser extent, guides should be regarded merely as background materials for reform. It is critical that international assistance has the expertise to analyze local circumstances, policies, and legal context, and reflect them in new secured financing legislation.

2. *Legal and registry reform should be part of one reform program.* The experience in Guatemala highlights an important feature of a secured financing reform program: it must be designed to include legal and registry reform. Each must be optimized for the other. A proposed law reform must consider the registry, which in turn must channel the law. Including both elements in one activity will save time and costs, and will ensure they are in harmony as they are developed.

E6. Tanzania: Kill No Bird with Two Stones

In 2008, USAID began an effort to modernize the Tanzanian secured financing system. The project was designed considering the country's constitutional structure (i.e., two subnational

jurisdictions) and envisioned the creation of two separate legal and registry systems. The reform approach was to allow these two systems to operate independently, but with no negative impact on each other.

During the course of USAID reform, another donor initiated a separate activity to reform the secured financing system of Zanzibar, one of the subnational jurisdictions in Tanzania. The international community found itself initiating duplicative reforms in Zanzibar.

The negative impact of this development extended beyond the waste of international donor funding; it had far worse ramifications. First, jurisdictional issues could create unnecessary confusion as movable property traveled between the two jurisdictions. Second, the possibility of movable property being removed from one part of the country to the other could increase the risk associated with advancing credit secured with movables. Third, using two registry systems meant transaction costs could increase. Fourth, lenders could insist on restricting the movement of goods from one part of the country to the other. Finally, increased costs resulting from increased IT staff and systems maintenance would have to be funded in the future.

E6a. Lessons Learned

1. *Use BizCLIR to project, detect and monitor related international activities.* A reform activity must constantly monitor existing and planned related activities that local and international organizations may initiate (e.g., leasing, bankruptcy, e-government, or tax reform). This monitoring exercise should take place throughout the activities, not only during the diagnostic phase. One goal of revising the BizCLIR indicators in 2007 was to increase donor coordination; now, BizCLIR assessments can provide a good platform to avoid collision and overlap. Such assessments can be a preliminary phase for reform and be used as a monitoring tool for a well-coordinated reform.

2. *Get two or more for one.* In jurisdictions with constitutional structures that do not allow a single national legal and registry system, reform can employ innovative IT approaches to accommodate constitutional requirements while maintaining the efficacy of the system. Such an approach can reduce long-term costs associated with maintaining a countrywide registration facility. It can also provide incentives to lenders to provide secured credit to borrowers regardless of their location or the location of the property.

E7. Georgia: One Wrong Can Make a Right

In 2007, the Georgian government embarked on a program to reform its secured financing system involving movable property. Donor disagreements over approach and political instability resulting from national and international crises slowed the initiative. The government, distracted by the crises and preoccupied with other reform activities, was unable to focus on a modern secured financing law reform. A modest law was eventually passed — but only after the business community put secured financing reform on its list of priorities at a meeting with the prime minister about what the government could do to mitigate the effects of the global financial crisis. Still, the secured financing legal reform remained limited; complete legal reform, the first pillar of secured financing reform, did not occur.

Legal reform failed to introduce a complete scheme of new priority rules among conflicting claims that determined rights in all situations, including bankruptcy. PMSIs were not a priority, and special provisions that would facilitate taking of security interests in special types of collateral (e.g., inventory, accounts receivable, crops, and warehouse receipts) were not introduced. Furthermore, expedited enforcement proceedings against movable property, including perishable goods, met with skepticism. One key feature that did pass was to give priority among completing claims based on the date of registration. This one change turned registration from a voluntary act that had no legal consequence to a source of certainty for creditors who did register their claims, making movables a viable source of collateral. The law also gave financial lessors the right and duty to register, eliminating conflicts with secured lending. Unlike in Rwanda, lessors in Georgia asked to be included in the registry.

Although the law is incomplete, the registry system is very good. It is designed to function as a fully Web-based registry system, a part of the reform that did not require passage of a full secured financing legislation, but instead was facilitated by a strong IT department within the government agency responsible for maintaining the registry. The significant efforts devoted to building the agency's understanding of modern secured finance resulted in wise decisions about software design: the system can handle current needs and future reforms. The agency adapted its very strong land registration system, ranked second internationally on the *Doing Business* "Registering Property" indicator, to create a secured financing registry that provides online registration and search capabilities. However, the agency still maintains paper-based archives, allowing customers to submit registrations and search directly within the registry.

To facilitate the move to a Web-based registry, the agency instituted a transitional period before the new registry took effect to re-enter all existing paper-based registrations into the new online database. It also provided training to financial institutions.

E7a. Lessons Learned

1. *Legal reform is optimal, but registry reform can be a step forward*. There is no substitute for modern legislation on secured financing to minimize the risks and transaction costs of dealing with movables. However, experience shows that registry system reform can take place without legal reform. The advantage of pursuing registry reform in this circumstance is that it reduces risks and costs to secured credit within the unreformed system. It also makes stakeholders aware of the advantages of modern computerized systems and, therefore, may trigger demand for further reform — including legal reform — to further simplify the use of movable property to generate credit.

2. *Public-private dialogue should be employed during the reform*. Public-private dialogue during the reform process may reveal the private sector's needs, which can generate the political support among government agencies necessary for complete reform.

3. *Local IT capacity may play a pivotal role in reform*. Often, large resources are spent on international IT expertise when local capacity is sufficient to develop and maintain modern registry systems. While in many cases high-level professional expertise exists primarily in the private sector, it may also be available within the public sector.

Notice Registry: A type of registry that publishes the claims of people who have rights in assets of other people. A notice-based registry does not require or determine the validity of the declaration. In this respect, it is much like the statements of income for the purpose of annual income tax filings in some jurisdictions.

Priority: The relative rank of a person's claim for satisfaction out of certain property in case of multiple, conflicting claims against the same property. Referred to as "preference" in some jurisdictions.

Priority Rules: A set of legal rules determining in what order conflicting claims to the same asset will be satisfied so those who wish to deal with movable property (e.g., lenders or purchasers) can predict the priority their interest will have in case of conflict with other claims to the same asset. The goal of the system is to facilitate risk assessment by lenders before the credit is advanced. Priority rules are set based on domestic policy considerations.

Publication: The registration of a claim to movable property in the secured financing registry. Publication of a claim is required to secure priority over others' claims. The procedural steps to achieve this public notice are delineated in a secured financing law.

Purchase Money Security Interest (PMSI): A specific interest in an asset or assets created in favor of a lender that financed the acquisition of the specific asset(s). It also serves as security for performance of the borrower's obligation. A PMSI has priority with respect to the specific financed asset(s) over other creditors of the same borrower.

Registration and Search Criteria: Protocols for computerized indexing and retrieving of data from a registry database. A protocol specifies the item or items of information under which a registration is archived and retrieved by users of the system. Validation rules of secured financing laws usually provide that a registration is valid only if this information is recorded accurately. The criteria for registration and for searching must be identical.

Related Legislation: This term refers to laws that may affect or be affected by a modern secured financing regime. Consideration of these laws is necessary to avoid conflict with other laws. Related legislation may include laws on leasing, liens, insolvency and bankruptcy, enforcement, law, tax, labor, and property law.

Search Result: A computer-generated report that includes all registrations retrieved under certain search criteria of a search request. In modern secured financing systems, search results provide the basis for determining the priority rank of conflicting claims.

Secured Financing Regulations: Regulations usually deal with the operation and administration of the registry, including the process of creating, amending, and deleting a registration, conducting queries of the registry database, other services provided by the registry, and, in some cases, the fees for such services.

Secured Financing System: The structure of legal and registry systems that regulate creation, priorities, and enforcement of secured transactions. Often referred to as a "secured transactions system."

Secured Transaction: Any transaction in which a certain asset is in substance, if not form, the security for performance of the obligor's obligation (e.g., secured loans, financial leases, and conditional sale transactions).

Seizure of Collateral: Taking possession of property to secure performance of an obligation. Seizure usually occurs when the lender initiates enforcement proceedings after the borrower fails to perform its contractual obligation.

Self-help Enforcement: An enforcement procedure that permits lenders to seize and dispose of property with no court order or public official involvement. This mechanism also includes means to protect the public peace in of case one of the parties (usually the borrower) refuses to employ self-help enforcement at the moment of seizure.

Subnational Jurisdiction: A lower level of government usually established under a constitutional structure. Subnational jurisdictions are constitutionally empowered to legislate and administer laws in certain areas exclusive of the national government.

Traffic Controller: The main function of secured financing systems. Modern secured financing systems provide a common platform for all commercial transactions involving movables as security to develop and operate without colliding or conflicting with each other. This is accomplished through the operation of a comprehensive set of priority rules (along with a registry system).

Transition Period: A period prescribed by the secured financing law during which old registrations can be re-registered in the new electronic registry.

Transition Provisions: Legal rules that govern how a country and its borrowers and lenders move from an old to a new secured financing system. A modern secured financing law includes a transitional period during which old registrations can be included in the new database(s) while maintaining their old priorities.

Validity of Registration: A legal matter usually regulated by the law. Validity depends on legal rules that determine when a registration has gained the status to acquire a priority rank. An invalid registration is not granted priority.

Warehouse Receipt: A document that provides proof of ownership of commodities stored in a warehouse. Warehouse receipts are usually issued by warehouse operators. They are transferable like other negotiable instruments (e.g., bank notes and checks).

Web-Based Registry: A computerized registry that provides a comprehensive and standardized method for users to register claims and conduct searches online. Registering and looking up

information online has become the most common and simple front-end method for the deployment of modern secured financing registries.

ANNEX B. REFERENCES

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