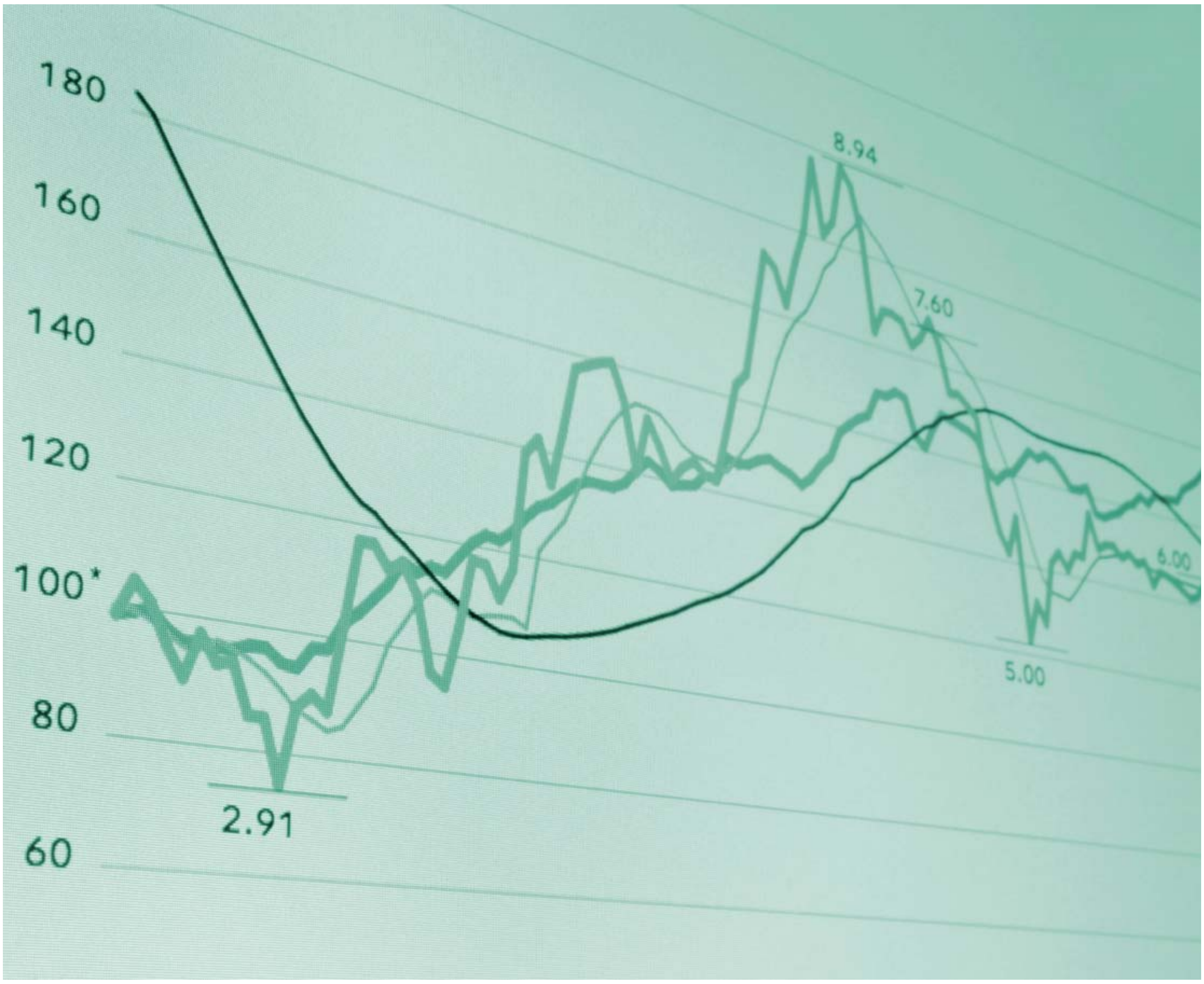
TECHNICAL PAPER

INCREASING ACCESS TO CREDIT

REFORMING SECURED TRANSACTION LAW



International Trade Centre

EXPORT IMPACT FOR GOOD

INCREASING ACCESS TO CREDIT

REFORMING SECURED TRANSACTION LAWS

Abstract for trade information services

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International Trade Centre (ITC)
Increasing Access to Credit: Reforming Secured Transaction Laws
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Study presenting a framework for developing modern secured transaction laws with a view to promoting the availability of secured credit to commercial enterprises - outlines the principles for an efficient secured transaction law, and provides a methodology for reforming such laws; describes the key features of a secured transactions legal framework, covering scope, creation of security rights, priority rules, effectiveness against third parties, development of a security right register, priority needs and and enforcement; provides a sample questionnaire which could be used to start a secured transactions law reform project.

Descriptors: **Commercial Law, Trade Financing, Credit.**

For further information on this technical paper, contact Mr Jean-François Bourque, Senior Legal Adviser (Trade Law and Arbitration)

English

The International Trade Centre (ITC) is the joint agency of the World Trade Organization and the United Nations.

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Foreword

This study invites national legislators as well as all those involved in enhancing the national business environment to consider secured financing schemes that will allow an increase in the amount of credit offered to SMEs. The reasoning is simple: allow as collateral property that SMEs usually possess; then build a framework so that banks can secure their loans on these collateral on the basis of priority rights over other creditors. As amounts secured are smaller in size, the system must be smarter/better/cheaper than the traditional security systems.

In the fall of 2008, the world financial system came to a near collapse. Following the various rescue plans there came a realization that changes must be made in national regulatory systems, especially with the view of a stronger oversight of megabanks.

Small and medium-sized enterprises (SMEs) were and are still directly hit by the unavailability and cost of credit. However, as George Affaki hints in his study, this is unjustified, considering the good mix of assets that SMEs can often demonstrate. Why then are SMEs as vulnerable to the consequences of the current crisis as larger companies? There is no stock answer but it seems clear that regulatory frameworks often disregard the particular circumstances in which SMEs operate.

This study could not be more timely. It takes the reader’s hand through a secured transactions system for SMEs and provides a very practical needs and impact analysis for a national legal reform project.

Acknowledgements

This technical paper has been written by Georges Affaki, Global Head of Specialized Financing (Energy, Commodities, Export, Project, Aircraft, Shipping and Global Trade Services (ECEP)) Legal Affairs at BNP Paribas, leading a 20 counsel team based in Paris and coordinating the activity of 71 specialized counsel worldwide. Mr. Affaki is also Vice-Chairman of the Banking Commission of the International Chamber of Commerce; Chairman or member of numerous panels in international banking dispute resolution proceedings (DOCDEX) organized under the aegis of the International Chamber of Commerce (ICC); Delegate to the United Nations Commission on International Trade Law (UNCITRAL) for the drafting of a legislative guide on secured transactions; Member of the Expert Panel on the UN Convention on Independant Guarantees and Stand-by Letters of Credit and on the UN Convention on the Assignment of Receivables in International Trade.

Jean-François Bourque, Senior Legal Adviser (Trade Law and Arbitration), supervised the work.

Agnès Barnéoud-Rousset ensured the layout.

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Acronyms

Unless otherwise specified, all references to dollars ($) are to United States dollars, and all references to tons are to metric tons.

The following abbreviations are used:

EBRD	European Bank for Reconstruction and Development
GRR	Global Recovery Rate
ICC	International Chamber of Commerce
IFC	International Finance Corporation
IMF	International Monetary Fund
ITC	International Trade Centre
OHADA	Organization for the Harmonization of Business Law in Africa/Organisation pour l'Harmonisation du Droit des Affaires en Afrique
PD	Probability of Default
SME	Small and Medium-Sized Enterprise
UCC	Uniform Commercial Code
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

Executive summary

The problem of small and medium-sized businesses in the developing world accessing finance does not lie in the particular composition of their assets. That composition generally reflects a good mix that is driven by technology, market prices, and the needs of markets - just as they do in industrial countries. Nor is the problem that the benefits of using collateral are unknown in low- and middle-income countries. The problem is that unreformed collateral systems do not accept as collateral as broad range of property as reformed systems do. Those businesses bother no longer to apply for loans because they know in advance that they will be unable to meet the lender's requirements for collateral. For these businesses, the reform of collateral laws is important to increasing their access to the financing they need to develop and operate in a competitive world.

A certain and predictable secured financing legal system will increase the credit amount that may be lent, lessen the cost of borrowing and enable loans to be made with a longer maturity. It should also help to build and develop a domestic economy by enabling private enterprise to develop and expand, increase markets and increase employment.

Those results occur because there is less risk to a lender that a loan or other form of credit will not be repaid. If the borrower, for whatever reason, becomes unable to repay the debt, the lender will be entitled to sell the secured asset and apply the proceeds of the sale toward payment of the debt. This is the essential difference between secured and unsecured credit. A secured creditor has priority over all unsecured creditors of a debtor because the secured creditor has an exclusive entitlement to the proceeds of sale of the secured asset.

The type of results that can be derived from secured lending will not be fulfilled unless the legal system provides a regime that offers an acceptable degree of transparency, certainty, flexibility and predictability. The persons who will need those types of assurances are the parties that are involved in the secured asset financing: the lender, the borrower and third parties who may be affected by it (for example another lender or a purchaser of the asset). All of these assurances and needs may only be provided through a modern and effective legal regime.

The purpose of this study is to propose a framework that assists States in the development of modern secured transactions laws with a view to promoting the availability of secured credit. The study is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States. It seeks to establish a balance among the interests of debtors, creditors, affected third persons and the State. In so doing, the study adopts the premise that all creditors will accept such a balanced approach as long as the laws are effective to enable them to assess their risks with a high level of predictability and with confidence that they will ultimately obtain the economic value of the encumbered assets in the event of non-payment by the debtor.

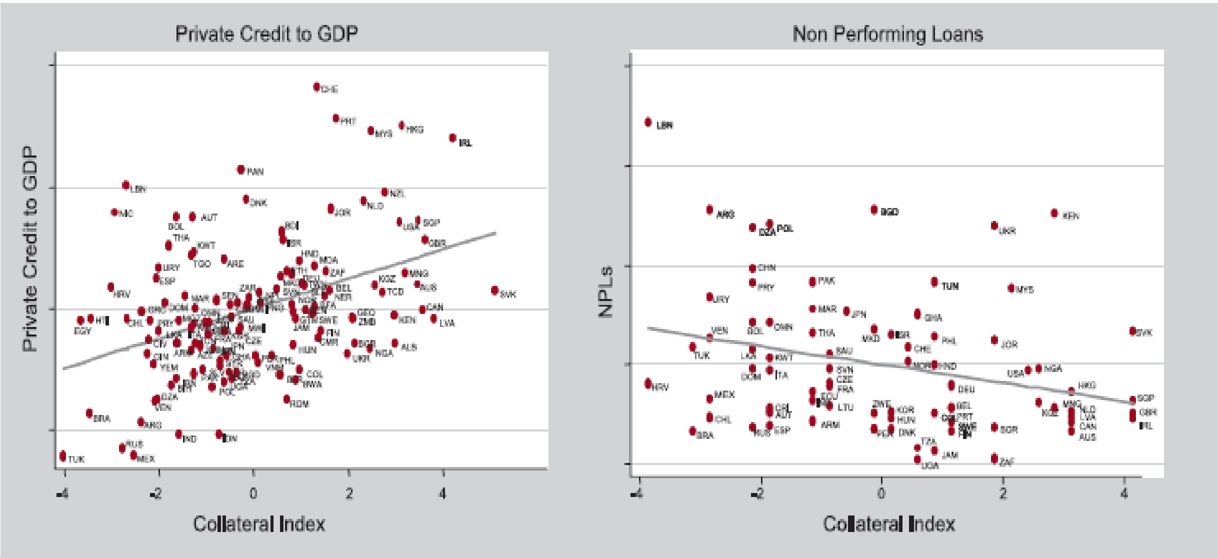
1. INTRODUCTION

1.1. The economic impact of secured transactions

The availability and cost of credit are directly influenced by the laws affecting secured transactions. Whether it be a micro business in the agricultural sector which needs to borrow money to buy a tractor, an enterprise which needs credit from its supplier, or the promoters of a power plant who need to finance a major new project, the inability to obtain valuable and efficient security over the debtor's assets is likely to discourage potential providers of credit.

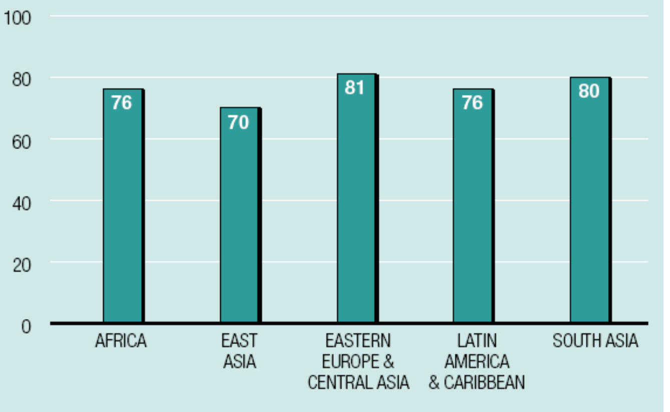
All businesses, whether manufacturers, distributors, service providers or retailers, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through empirical studies conducted by such organizations as the World Bank, the International Monetary Fund (IMF), the Asian Development Bank and the European Bank for Reconstruction and Development (EBRD) that one of the most effective means of providing working capital to commercial enterprises is through secured credit. A creditor will not extend credit – whether a loan or a payment facility – if he is not convinced that such credit will be repaid. While this is dependent on the ability of the debtor to generate the required cash flow, the projected flows can be disturbed by a change of circumstances, and the creditor will still want certainty that, should the debtor experience financial difficulties, he can still get repaid. Hence the expectation of the creditor that, in case of default, a security right will identify and dedicate certain debtor's assets for the exclusive benefit of the creditor, who could seize and sell them in case of default and receive the proceeds of sale ahead of other creditors.

Box 1: Diagram demonstrating the corollary between a more efficient collateral, increasing credit and fewer defaults



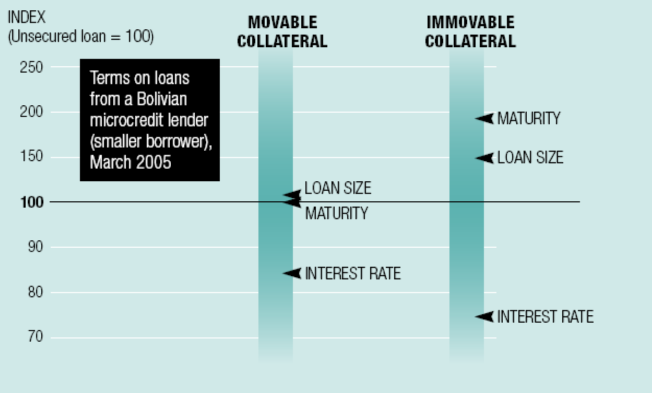
Source: *Doing Business in 2005,* World Bank.

Box 2: Study on the percentage of businesses required to pledge collateral compared to the number of businesses that applied for credit



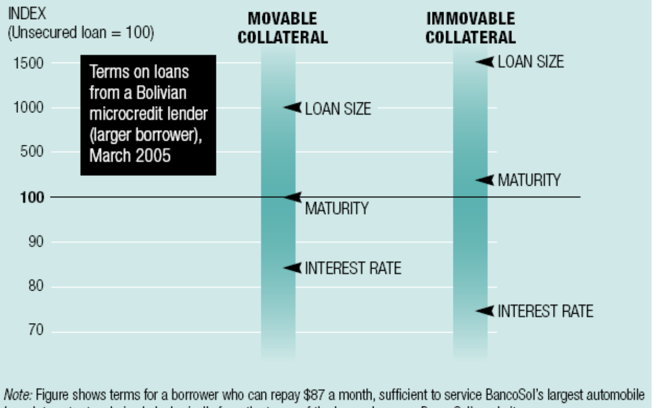
Note: Data are from surveys conducted in more than 60 countries in 2001–05.
Source: World Bank Group, Enterprise Surveys (http://rru.worldbank.org/EnterpriseSurveys).

Box 3: The efficiency of collateral and its impact on small microfinance loans, immovable collateral being considered as more efficient in pre-reform systems



Note: Figure shows terms for a borrower who can repay $87 a month, sufficient to service BancoSol's largest unsecured loan. Interest rates derived algebraically from the terms of the loans shown on BancoSol's website.
Source: Banco Solidario (http://www.bancosol.com.bo/en/productors_cr.html).

Box 4: The efficiency of collateral and its impact on large microfinance loans, immovable collateral being considered as more efficient in pre-reform systems



Note: Figure shows terms for a borrower who can repay $87 a month, sufficient to service BancoSol's largest automobile loan. Interest rates derived algebraically from the terms of the loans shown on BancoSol's website.
Source: Banco Solidario (http://www.bancosol.com.bo/en/productors_cr.html).

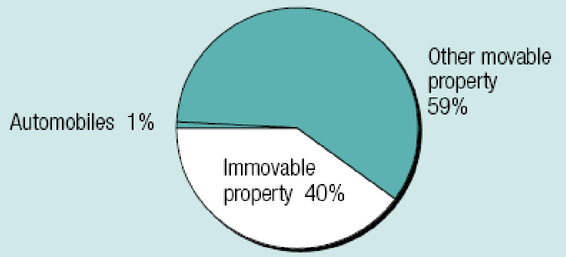
The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing risk for the creditor. Risk is reduced because credit secured by assets gives creditors access to the assets as another source of payment in the event of non-payment of the secured obligation. As the risk of non-payment is reduced, the availability of credit is likely to increase and the cost of credit is likely to fall.

1.1.1. Optimizing the use of assets as collateral

Secured lending experience shows that it is wrong to consider that it is the lack of sufficient assets to serve as collateral that limits businesses in low- and middle-income countries accessing finance. Businesses generally have assets that could be used as security for loans–movable assets such as the goods they produce or process, the machinery they use in manufacturing, present and future accounts receivable from clients, intellectual property rights, and warehouse receipts. Around the world movable assets, rather than land or buildings, account for most of the capital stock of private businesses and an especially large share for micro, small, and medium-sized enterprises.

Box 5: Most enterprise assets in industrial countries are movable

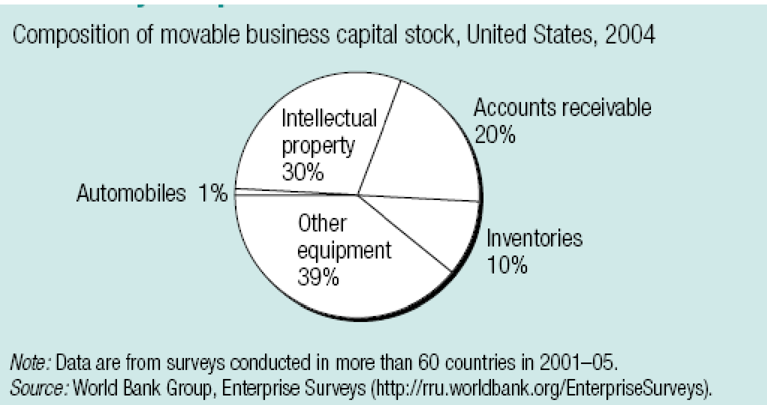
Composition of business capital stock, United States, 2004



Source: U.S. Department of Commerce, Board of Governors of the U.S. Federal Reserve System, and U.S. National Science Foundation.

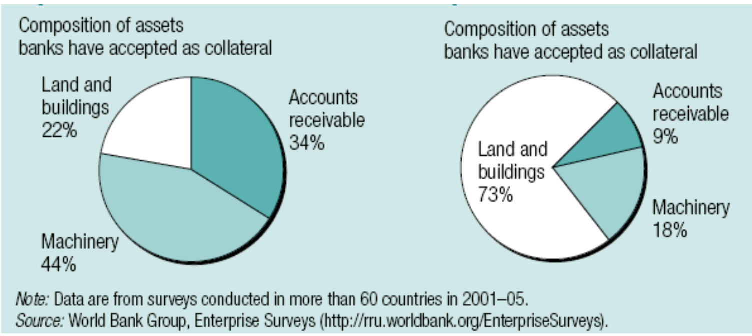
In the industrial countries with the most advanced legal systems for collateral – Canada, New Zealand, and the United States – lenders consider such assets to be excellent sources of collateral. Regrettably, most of the rest of the world's businesses face a very different situation. In most low- and middle-income countries only urban real estate and to a lesser extent new motor vehicles can serve as collateral. For businesses in some sectors, such as urban transport companies, some heavy utilities, and commercial office buildings, this system of finance works. But for other enterprises it means that little of the property they own can serve as collateral. A closer look at what makes up the movable capital stock tells more about the disparity in businesses' ability to use as collateral the assets they have or will need to have as they develop. Businesses in the developed world hold movable capital stock in a wide range of categories, all of which would be considered excellent collateral by lenders (Box 6). Yet most of this capital could not serve as collateral in a low- or middle- income country with an unreformed collateral system. To take one example, a World Bank report indicates that nearly 99% of movable property that could serve as collateral for a loan in the United States would likely be unacceptable to a lender in Nigeria.

Box 6: Movable assets in industrial countries are wide-ranging and widely accepted as collateral



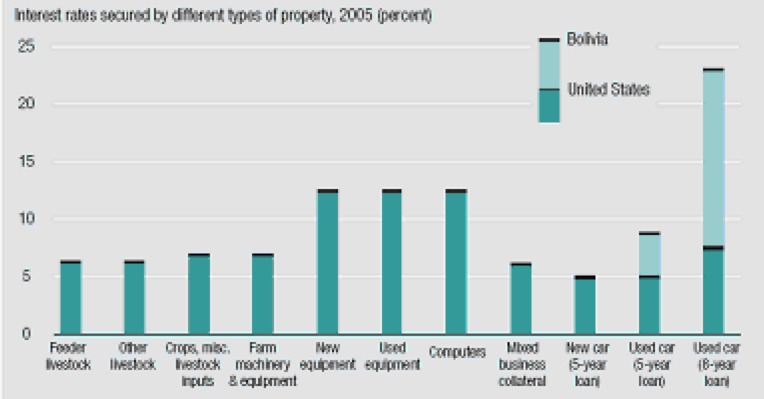
The above empirical studies show the important mismatch in low- and middle-income countries between the type of assets that businesses have, or will need to have, and the type of assets that lenders can accept as collateral (Box 7) – and **it is this mismatch that explains the lack of access to credit**. Businesses seeking to finance equipment that is not acceptable as collateral are often forced to rely on non-commercial funding sources, which can be both scarce and extremely expensive.

Box 7: The mismatch in low- and middle income countries between the assets businesses own and what lenders accept as collateral



For the avoidance of any misunderstanding, the problem of businesses in the developing world accessing finance does not lie in the particular composition of their assets. That composition generally reflects a good mix that is driven by technology, market prices, and the needs of markets. Thus productive assets consist of a wide range of equipment, inventories, and accounts receivable – just as they do in industrial countries. Nor is the problem that the benefits of using collateral are unknown in low- and middle-income countries. Indeed, where the collateral system works, these countries see much the same outcome as countries with modern systems do. World Bank studies show, for example, that interest rates for loans secured by automobiles in Bolivia differ from those in the United States by about the same amount as Bolivia's country risk premium. Put another way, full macroeconomic stabilization in Bolivia would give Bolivians access to credit for purchasing automobiles similar to that enjoyed by American residents. The problem is that this effect of collateral does not extend to other movable property in Bolivia. So while American borrowers can readily obtain loans for a broad range of movable property, Bolivian borrowers seeking loans for many of the same types of property could not even get interest rates quoted (Box 8).

Box 8: An unreformed system for collateral puts borrowers at a big disadvantage



Note: Data are from surveys conducted in more than 60 countries in 2001–05.
Source: World Bank Group, Enterprise Surveys (http://rru.worldbank.org/EnterpriseSurveys).

Box 9: Jurisdictions with modern secured transactions have more favourable credit policies for borrowers

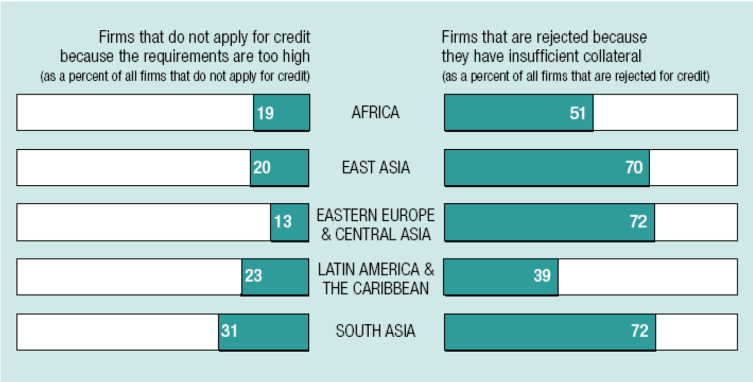
LOAN-TO-VALUE RATIOS			
TYPE OF COLLATERAL	**OECD**	**EMERGING MARKETS**	
		Friendly/Reformed	**Difficult/Unreformed**
FIXED – Real Estate	Up to 90%	Up to 80%	Between 60%-80% (cities) 30%-60% (rural areas)
MOVABLE			
Vehicles	Up to 100%	Between 70% and 100%	Between 60% and 85%
Equipment	Up to 80%	Up to 80%	From 60% to 80%. Most times no value (secondary collateral)
Accounts	Up to 80%	Up to 50%	No value (secondary collateral)
Inventory	Up to 50%	No value (secondary collateral)	No value (secondary collateral)

Source: International Finance Corporation.

This example is not unique. In most low- and middle-income countries, once country risk premiums are removed, interest rates for loans secured by new cars or urban real estate are similar to those charged in industrial country markets.

Most businesses face collateral requirements they cannot meet and get none of the benefits of collateral from the assets they own. Across developing countries, when businesses apply for a loan or a line of credit, the most common reason that their application is rejected is insufficient collateral (Box 9). Regrettably, those businesses bother no longer to apply for loans because they know in advance that they will be unable to meet the lender’s requirements for collateral. For these businesses, the reform of the laws governing the use of collateral is important to increasing their access to the financing they need to develop and operate in a competitive world.

Box 10: Many businesses in low- and middle-income countries cannot meet collateral requirements for loans



Note: Data are from surveys conducted in more than 60 countries in 2001–05.
Source: World Bank Group, Enterprise Surveys (http://rru.worldbank.org/EnterpriseSurveys).

1.1.2. Benefits to the country of reform

Sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses (particularly small and medium-sized enterprises) and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making consumer credit more readily available. To be effective, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws.

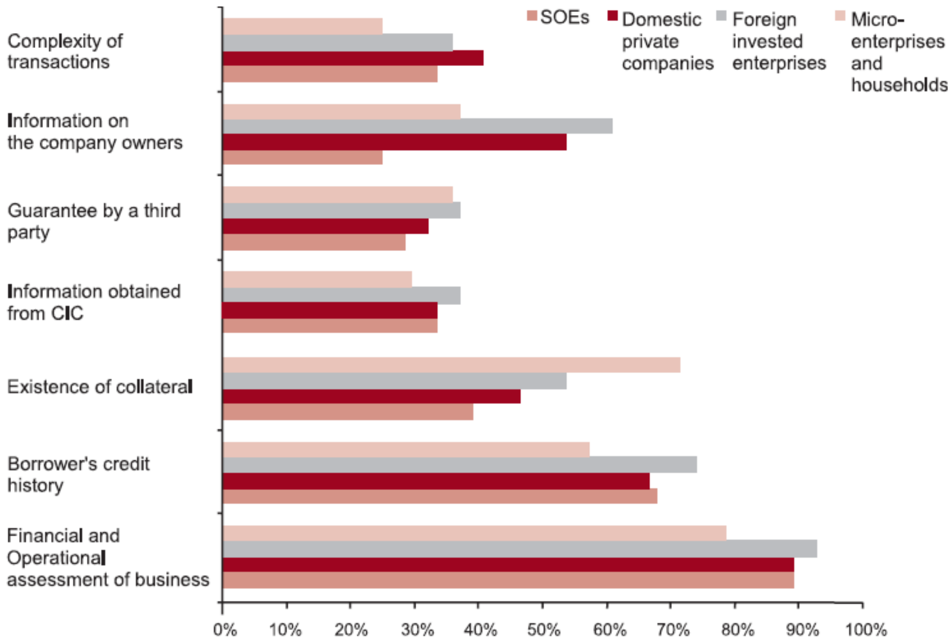
The objective of reform of secured transactions laws is primarily economic. A lender or creditor will take a security in order to reduce the risk of losing the money that he is owed. If the law or the way in which it is applied does not give creditors confidence that they can recover real value from the collateral it will have little economic effect. On the other hand, a **security system which effectively reduces the risk of giving credit can increase the availability of credit and improve the terms on which it is available**. A lender who knows that he has legally recognized rights to turn to his debtor's assets in case of non-payment will assess the credit risk quite differently. The availability of such recourse may influence his decision whether to give credit or not. If he does give credit it will also affect the price for such credit.

True, it can be argued that security is not necessarily a condition for credit. In developed economies, credit cards are a common means by which people and businesses borrow on credit. Blue chip companies routinely borrow unsecured. Security is not, in itself, a sufficient guarantee of repayment either – as mentioned above, prudent lending requires adequate credit analysis to assess the ability of the borrower to repay from income, cash flow, or profits. Security, however, is very likely to encourage and enhance credit by changing the terms on which the creditor is prepared to lend, typically by:

- Increasing the amount of the loan.
- Extending the period for which the loan is granted.
- Lowering the cost of the credit.

The establishment of an attractive legal and regulatory framework for taking security over movable assets constitutes one of the building blocks stimulating secured lending. Developing countries have increasingly paid attention to this area of the law to reap these benefits. An advanced legal regime, properly implemented, should encourage the use of security and therefore facilitate access to credit and/or reduce borrowing cost.

Box 11: Factors for making business loan decisions



Source: *IFC-VBA Financial Sector Survey.*

1.1.3. Calculating the credit price under an efficient collateral system

An example tracking a bank credit assessment financial model illustrates the above. At the outset, it should be recalled that banks are subject to regulatory capital requirements for prudential purposes. This requires them to hold total capital equivalent to at least 8% of their risk–weighted assets. The Revised international capital framework (Basel 2) has not changed this feature of the initial Capital Accord (Basel 1). What has actually changed is the risk weighting rules. Simply put, instead of setting aside eight units of capital for each 100 units of credit granted, eight units of capital have now to be set aside for the risk–weighted equivalent of the credit granted which could range from 0% (therefore effectively dispensing with any obligation to set aside equivalent capital) to 1250% of the amount of credit (in effect resulting in 100% of the credit amount being set aside in capital equivalent (1250% x 8%)). It is this risk–weighting equivalent of credit that is directly influenced by the efficiency of the security.

Take a bank loan of 3,000 made to a borrower presenting a 1% default probability from a creditworthiness standpoint. Suppose that the bank takes a security over a collateral of a value of 4,000. Suppose also that that collateral is situated in a country that allows the secured lender to take a proprietary right over the collateral, make it effective against other competing claimants through a formality that would publicize that right, such as notice registration, and to foreclose on the collateral in the event of default through a rapid, certain and inexpensive procedure, including in the event of bankruptcy of the grantor. In this case, the lender certainly benefits of a high expectation of recovery due to the efficiency of the security system which allows a security right to be perfected through registration on a public registry that enhances predictability and certainty and to be realized through a certain, predictable and inexpensive procedure.

If the lending bank considers that the expected rate of return of an enforcement of the security is 60% (in effect recovering 2,400 out of the nominal value of the collateral), and hence a global recovery rate (GRR) on the extended credit of 80%, capital adequacy obligations would compel the bank to hold 95.52 in capital. This figure is the result of the crossing on the risk–weighting table in Box 1 of the probability of default (PD) and the GRR: 39.8%

Box 12: Basel 2 risk-weighting table

PD / GRR in %	0.03%	0.48%	1%	13.32%	21.81%
80	7.24%	29.2%	39.8%	122.0%	156.2%
70	10.85%	43.8%	59.6%	183.0%	234.3%
60	14.47%	58.4%	79.5%	244.0%	312.4%
50	18.09%	72.9%	99.4%	305.0%	390.5%
40	21.71%	87.5%	119.3%	366.0%	468.6%
30	25.33%	102.1%	139.2%	426.9%	546.7%
20	28.95%	116.7%	159.1%	487.9%	624.8%
10	32.56%	131.3%	178.9%	548.9%	702.9%

Source: BNP Paribas.

Applied to the credit in the example given above:

3,000 x 39.8% = 1,194 risk–weighted equivalent of the credit

1,194 x 8% = 95.52

Accordingly, the capital that the lending bank would have to hold in the example of a loan of 3,000 secured by the collateral in the conditions described above is 95.52.

This capital has to generate a return that meets the rate set by the bank, say 20%, which gives 4.7.

Let's vary now a single parameter of this example: consider that the same collateral (same type of asset and same value) is displaced to a jurisdiction where the secured creditor is not allowed a proprietary right certain over the collateral that would rank ahead of competing claimants in the event of bankruptcy. This limitation could be due to a wide variety of defects in the secured transaction system, including, for example, the absence of a public registry for security rights in the jurisdiction where the collateral is situated, or the length, cost and contingency of the security enforcement procedure.

The lending bank could in such a case consider that the return rate expected from the enforcement of the security is 7.5%, thus leading to a GRR of 10% of the extended credit. Capital adequacy rules would require the bank in this case to hold capital for an amount of 429.36.

Crossing the new parameters on the table in Box 1 above shows a risk–weight of 178.9%. Applied to the credit:

3,000 x 178.9% = 5,367

5,367 x 8% = 429.36

The credit in this case will use 429.36 of the bank's capital, which has to generate the same rate of return as the one fixed earlier: 20%, which gives us: 85.87.

The above example demonstrates how an inefficient security requires the bank to use 4.5 times more capital than an efficient one: (429.36 – 95.52) and will cost 4.5 times more (85.87 – 19.10).

It would be a mistake to believe that the riskier the transaction the greater the return to the bank. The bank's rate of return on capital in the example above is 20%. This rate does not vary. The bank has to charge a higher spread to achieve that return when the increased risk requires using a higher capital. At the end, the borrower ends up paying more by way of credit cost when the security is inefficient.

It is precisely for this reason: getting credit (including international bank finance) at a more reasonable cost that a number of eastern European and CIS countries have accompanied their transition to market economy by the enactment of a modern secured transaction system. Other developing countries are seeking actively a similar approach. This is the reason, for example, behind the revision of the 1997 Uniform Act on Security Rights of the Organization for the Harmonisation of Business Law in Africa (OHADA). It is important for the success of their project and to meeting their objective in attracting capital with a view of increasing the availability of low-cost credit that developing countries conduct the necessary reform to their secured transactions laws methodically and with careful planning.

Secured transactions reform is now widely recognized as a cornerstone of economic development. For example, the World Bank Annual Reports "Doing Business", which investigate and compare regulation enhancing business activities in 175 economies, have included one full chapter out of ten on "Getting Credit", which covers secured transactions. International and bilateral financial institutions (the Asian Development Bank, World Bank, Inter–American Development bank, Millennium Challenge Corporation, UN Commission on International Trade Law, etc.) have also promoted, in one form or another, reform in this area of the law. A considerable amount of material is thus available on the subject from and including the following resources:

- Basic requirements of the legal system to support the economic aspects of the reform (e.g. EBRD Core Principles for Secured Transactions Law, World Bank General Principles on Insolvency Law and Creditors' Rights).
- Illustration and model on how legal provisions can be drafted (e.g. EBRD Model law) or registration systems developed (e.g. Asian Development Bank study to Movables Registries).
- Background material and recommendations on secured transactions law (e.g. UNCITRAL Legislative study on Security rights over Movable Property).
- National laws and regulations now adopted in many emerging countries on the subject.

This study builds on all of the above.

1.2. Terms of reference to this study – Methodology

The purpose of this study is to assist States in the development of modern secured transactions laws with a view to promoting the availability of secured credit. The study is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States.

This study seeks to rise above differences among legal regimes to offer pragmatic and proven solutions that can be accepted and implemented in States regardless of their legal tradition. The focus of the study is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable, though limited, costs to develop and implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.

The legal regime envisaged in the study is a purely domestic regime. It is addressed to national legislators considering reform of domestic secured transactions laws. However, because secured transactions often involve parties and assets located in different jurisdictions, it is essential that security rights and title-based security devices, such as retention of title in tangible property and financial leases, effectively created in other jurisdictions be recognized. This would represent a marked improvement for the holders of those rights over the laws currently in effect in many States, under which such rights often are lost once an encumbered asset is transported across national borders, and would go far towards encouraging creditors to extend credit in cross-border transactions, a result that could enhance international trade.

Throughout, the study seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, such as buyers and other transferees of encumbered assets, and the State. In so doing, the study adopts the premise, supported by substantial empirical evidence, that all creditors will accept such a balanced approach and will thereby be encouraged to extend credit, as long as the laws (and supporting judicial and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately obtain the economic value of the encumbered assets in the event of non-payment by the debtor.

Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization or liquidation of a business. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the study will apply to many forms of consumer transactions, it is not intended to override consumer-protection laws or to discuss consumer–protection policies, since these matters do not lend themselves to unification.

Finally, although a secured transaction law can be about all forms of property (immovable and movable), this study is solely about using **movable assets** to provide security. It does not deal with immovable property. Similarly, this study does not deal with specific assets that would warrant a special treatment as concerns effectiveness or priority, such as bank accounts, negotiable instruments or documents, independent undertakings and securities. Although all those assets constitute valuable collateral, the purpose of this study is to provide an overview of the essential broad features of a successful secured transaction system and the methodology to achieve it. Specialized textbooks and other international organization works on the subject can supplement this study with the necessary detail for each of those assets.

Methodology. This study brings together the author's experience in secured and asset finance in developing countries, his interaction with businesses and governments for over a decade in discussing the conditions of access to bank lending and outlining necessary collateral reform, his association with and contribution to international organizations working in the area of secured transaction law reform and, finally, research papers, market reports and group and private discussions with organizations and individuals relating to secured transaction law reform.

1.3. Examples of financing practices covered in the study

Short examples of the types of secured credit transactions that the study contemplates are set out below. These examples represent only a few of the numerous forms of secured credit transactions currently in use and an effective secured transactions regime must be sufficiently flexible to accommodate many existing methods of financing, as well as methods that may evolve in the future. They have been selected because of their particular adaptability to the financing needs of small and medium-sized businesses.

1.3.1. Inventory and equipment acquisition financing

Businesses often obtain financing for specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the tangible property (inventory and equipment) purchased. In other cases, the financing is provided by a lender. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller. The seller retains title or the lender is granted a security right in the tangible property purchased to secure the repayment of the credit or loan.

Here is an illustration of acquisition financing: ABC Manufacturing Company (ABC), a manufacturer of furniture, wishes to acquire certain inventory and equipment for use in manufacturing operations. ABC desires to purchase paint (constituting raw materials and, therefore, inventory) from Seller A. ABC also wishes to purchase certain drill presses (constituting equipment) from Seller B and certain conveyor equipment from Seller C. Finally, ABC wishes to lease certain computer equipment from Lessor A.

Under the purchase agreement with Seller A, ABC is required to pay the purchase price for the paint within 30 days of Seller A's invoice to ABC, and ABC grants to Seller A a security right in the paint to secure the purchase price. Under the purchase agreement with Seller B, ABC is required to pay the purchase price for the drill presses within 10 days after they are delivered to ABC's plant. ABC obtains a loan from Lender A to finance the purchase of the drill presses from Seller B, secured by a security right in the drill presses. ABC also maintains a bank account with Lender A and has granted Lender A a security right in the right to payment of funds credited to the bank account as additional security for the repayment of the loan.

Under the purchase agreement with Seller C, ABC is required to pay the purchase price for the conveyor equipment when it is installed in ABC's plant and rendered operational. ABC obtains a loan from Lender B to finance the purchase and installation of the conveyor equipment from Seller C, secured by a security right in the conveyor equipment.

Under the lease agreement with Lessor A, ABC leases the computer equipment from Lessor A for a period of two years. ABC is required to make monthly lease payments during the lease term. ABC has the option (but not the obligation) to purchase the equipment for a nominal purchase price at the end of the lease term. Lessor A retains title to the equipment during the lease term but title will be transferred to ABC at the end of the lease term if ABC exercises the purchase option.

In each of the above four cases, the acquisitions are made possible by means of acquisition financing provided by another person (seller, lender or financial lessor) who holds rights in the acquired property for the purpose of securing the acquisition financing granted. As the example make clear, acquisition financing can occur with respect to both inventory and equipment.

1.3.2. Inventory and receivable revolving loan financing

Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections.

One highly effective method of providing such working capital is a revolving loan facility. Under this type of credit facility, loans secured by the borrower's existing and future inventory and receivables are made from time to time at the request of the borrower to fund the borrower's working capital needs. The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Thus, borrowings and repayments are frequent (though not necessarily regular) and the amount of the credit is constantly fluctuating. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, processing inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower, and helps the borrower to avoid borrowing more than it actually needs.

Here is an illustration of this type of financing: It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving loan facility to ABC to finance this process. Under the loan facility, ABC may obtain loans from time to time in an aggregate amount of up to 50 per cent of the value of its inventory that Lender B deems to be acceptable for borrowing (based upon the type and quality of the inventory, as well as other criteria) and of up to 80 per cent of the value of its receivables that Lender B deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the debtors of the receivables). ABC is expected to repay these loans from time to time as it receives payments from its customers. The loan facility is secured by all of ABC's existing and future inventory and receivables. In this type of financing, it is also common for the lender to obtain a security right in the right to payment of funds credited to the bank account into which customer payments (i.e. the proceeds of inventory and receivables) are deposited.

1.3.3. Receivable discounting

Receivable discount is a highly effective form of receivables financing that can trace its roots back thousands of years. In general, discounting involves the outright purchase of receivables from the grantor, as seller (assignor) to the discounter or factor (assignee). Such an outright transfer of receivables falls within the definition of a security right for purposes of the study.

There are a number of different types of discounting arrangement. The assignee may pay a portion of the purchase price for the receivables at the time of the purchase, only when the receivables are collected, or on the average maturity date of all of the factored receivables. The assignment of the receivables can be with or without recourse to the assignor in the event of non-payment of the receivables by the debtors of the receivables (i.e. the customers of the assignor). Finally, the debtors of the receivables may be notified that their receivables have been the subject of discounting, or they may not be so notified. When notice is given to the customers, it is often accomplished by requiring the assignor to place a legend on the invoices that the assignor sends to its customers.

Where receivable discounting takes place under a factoring umbrella, the factor may also perform various services for the assignor in respect of the receivables, ranging from approving and evaluating the creditworthiness of the debtors of the receivables, performing bookkeeping duties and engaging in collection efforts with respect to receivables that are not paid when due. These services can provide a useful benefit to companies that do not have their own credit and collection departments.

Here is an illustration of a typical receivable discounting arrangement: ABC enters into a discount arrangement with Assignee, pursuant to which Assignee agrees to purchase receivables that Assignee deems to be creditworthy. Assignee advances to ABC an amount equal to 90 per cent of the face value of such receivables, holding the remaining 10 per cent as a reserve to cover potential customer claims and allowances that would reduce the value of the receivables.

1.3.4. Term loan financing

Businesses often need financing for large, non-ordinary-course-of business expenditures, such as the acquisition of significant equipment or the acquisition of a business. In these situations, businesses generally seek loans that are repayable over a fixed period of time (with principal being repaid in monthly, quarterly or other periodic instalments pursuant to an agreed-upon schedule or in a single payment at the end of the loan term).

As is the case with many other types of financing, a business that does not have strong, well–established credit ratings will have difficulty obtaining term loan financing, unless the business is able to grant security rights in its assets to secure the financing. The amount of the financing will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered. In many States, immovable property is the only type of asset that typically is accepted by lenders to secure term loan financing and, as a result, in such States term loan financing is often not available for other important asset types, such as equipment or the enterprise value of an entire business. This is most likely the case in States that do not have a modern secured transactions regime. However, many businesses, in particular newly established businesses, do not own any immovable property and, therefore, may not have access to term loan financing. In other States, term loans secured by movable property, such as equipment, intellectual property and the enterprise value of the business, are common.

Here is an illustration of this type of financing: ABC desires to expand its operations and purchase a business. ABC obtains a loan (predicated on the value of, and secured by, substantially all of the assets of the business being acquired) from Lender C to finance such acquisition. The loan is repayable in equal monthly instalments over a period of 10 years and is secured by existing and future assets of ABC and the entity being acquired.

1.3.5. Transfer of title for security purposes

In States that honour a form of transfer of ownership even when it does not entail a transfer of possession and is done for financing purposes, a transaction denominated as a transfer of title by way of security (or sometimes as a “fiduciary” transfer of title) is recognized. These transactions are essentially non-possessory security rights, and they are primarily used in States where the secured transactions law has not yet generally recognized non-possessory security rights.

1.3.6. Sale and leaseback transactions

A sale and leaseback transaction provides a method by which a company can obtain credit based upon its existing tangible property (usually equipment) while still retaining possession and the right to use the tangible property in the operation of its business. In a sale and leaseback transaction, the company will sell its assets to another person for a specific sum (which the company may then use as working capital, to make capital expenditures or for other purposes). Simultaneously with the sale, the company will lease the equipment back from that other person for a lease term and at a rental rate specified in the lease agreement.

2. PRINCIPLES FOR AN EFFICIENT SECURED TRANSACTION LAW

It is tempting for lawmakers contemplating a reform of their secured transactions law, and the international organizations and consultants advising thereon, to copy into their legal system an existing legal framework of a chosen jurisdiction (e.g. the secured transaction system in the United States, in Canada or in New Zealand). This is usually done because the promoters of the reform perceive the model system as reflective of an economical model (and sometimes social and cultural values as well) that they associate with the result that they intend to achieve. Such an approach would be a serious error and could lead to the failure of the reform if it does not integrate in the existing legal framework and the societal values and idiosyncrasies of the enacting country.

No preset concept of reform should be imposed on a country, whether or not that concept reflects an existing legal framework in a jurisdiction. There may be many ways of reaching the sought result in enhancing the availability of credit, decreasing its cost and being conducive to a higher rate of economic growth. The correct approach should be result-driven while ensuring that the best practice based principles adopted for the reform are compatible with the law and practice of the particular country.

2.1. The law should allow the utilisation of the full value of as broad a range of assets as possible to support credit in the widest possible array of secured transactions

A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the study emphasizes the importance of comprehensiveness, by:

- Permitting a broad range of assets (including present and future assets) to serve as encumbered assets.
- Permitting the widest possible array of obligations (including future and conditional and monetary and non-monetary obligations) to be secured by security rights over collateral.
- Extending the benefits of the regime to the widest possible array of debtors, creditors and credit transactions.

2.2. The law should enable parties to obtain security rights in a simple and efficient manner

The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the study suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include:

- Eliminating unnecessary formalities.
- Providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets.
- Permitting security rights in future assets and for future advances of credit without any additional documentation or action by the parties.

2.3. The law should seek to provide for equal treatment of diverse sources of credit and of diverse forms of secured transactions

Because healthy competition among all potential credit providers is an effective way of reducing the cost of credit, the study recommends that the secured transactions regime apply equally to various credit providers, including banks and other financial institutions, and suppliers, as well as domestic and non-domestic creditors.

2.4. The law should validate non-possessory security rights

Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, the study recommends that the legal regime provide for non-possessory security rights in a broad range of assets coupled with a mechanism in the form of a public registry for providing notice to third parties as to the possible existence of such security rights.

2.5. The law should enhance predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules

Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a secured transaction, the study seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting and addressing confidentiality concerns.

2.6. The law should establish clear and predictable priority rules

A security right in assets will have little or no value to a creditor unless the creditor is able to ascertain, at the time a transaction is concluded, the priority of its right in such assets relative to the rights of other creditors (including an insolvency representative). Thus, the study proposes the establishment of a general security rights registry and, based on that registry, clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

2.7. The law should facilitate enforcement of creditors' rights in a predictable and efficient manner

A security right will have little or no value to a secured creditor unless the creditor is able to enforce the security right in a predictable and time– and cost-efficient manner. Thus, the study proposes procedures that allow secured creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The study also recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate rules of insolvency law.

2.8. The law should balance the legitimate interests of affected persons including the debtor, other grantors, competing creditors, such as secured, privileged and unsecured creditors, purchasers and other transferees of the encumbered assets, and the State

Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors, such as secured, privileged and unsecured creditors, purchasers and other transferees of the encumbered assets, and the State, the study proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.

2.9. The law should recognize party autonomy so as to accommodate new and evolving forms of secured transactions

Because an effective secured transactions regime should provide maximum flexibility to encompass a broad array of secured transactions, and also to accommodate new and evolving forms of secured transactions, the study stresses the need to keep mandatory rules to a minimum so that parties may tailor their secured transactions to their specific needs. At the same time, the study takes into account that other legislation may protect the legitimate interests of consumers or other persons and specifies that a secured transactions regime should not override such legislation.

2.10. The law should harmonize secured transactions laws, including private international law rules, with an aim to facilitating regional integration

Adoption of legislation based on the recommendations contained in this study will result in harmonization of secured transactions laws (through the adoption of similar substantive laws which will facilitate the cross-border recognition of security rights). This result in itself will promote the financing of international trade and the movement of goods and services across national borders. Furthermore, to the extent complete harmonization of national secured transactions laws might not be achieved, private international law rules would be particularly useful to facilitate cross-border transactions. In any event, private international law rules would be useful in order, for example, to help secured creditors determine how to make their security rights effective against third parties (i.e. under the law of the location of the encumbered assets, the law of the location of the grantor or another law).

3. THE REFORM PROCESS

The subject of secured transactions law reform is relatively complex and there is no consensus on how a legal framework should be designed to fully generate the sought impact on the local economy. Secured credit markets operate differently from one jurisdiction to the other and policy choices and implementation challenges will ultimately rest on the particular jurisdiction. It is thus essential that time and effort is invested by the reform project stakeholders during the project to:

- Understand the economic objectives of the reform.
- Balance and decide upon different options according to their respective costs and benefits.
- Decide on what will be best for the country in the near and medium term.
- Regularly review progress against the agreed objectives.

Experience has shown that the most successful reforms are those which are clearly owned and actively led and promoted by the local stakeholders.

3.1. Implementing the reform – A methodology

Box 13: Reform project chart

Goal:	**Objectives**:	**Activities/ Inputs**:	**Output**:	**Outcome**:	**Impact**:
What do we want to change?	What should be implemented to achieve the desired change?	Physical actions and resources	Direct results from the Activities. Have immediate or short term effect during the project timeframe.	The expected effect. Measures the achievement of Objectives. Observed during the project life and up to 3 years after completion.	Desired final change. Measures the achievement of Goals. Has effect within 3-5 years or longer after completion, rarely during the project timeframe.

Source*:* International Finance Corporation.

A successful reform of the law of secured transactions requires the enactment of a new law and accompanying implementing regulation. It is key for the success of the reform that a project manager is appointed at the outset. While it is recommended that the manager be experienced in the legal and economic framework of the country where the reform is contemplated, and ideally be appointed by the government of that country, it can also be contemplated that the manager be a senior officer of the international financial organization which is sponsoring and advising on the reform.

Among the most important tasks is to build, at the outset, a persuasive case for the reform. The more persuasive that case is, the stronger the position of the stakeholders advocating for the reform will be and the easier it will be to get agreement on the reform. The key to reaching a voluntary agreement on reform with the government is a law that seem reasonable to the interested parties.

A good place to set out the detailed case for reform is the assessment study. Its analysis can be reinforced by commentaries in the draft law giving the motivation, legal background, and economic logic underlying the drafting of the proposed law. The full package – the assessment study, draft law, and implementing regulation – will need to be defended in a training and public awareness program that addresses all stakeholders' concerns, whether or not those concerns are well founded. Putting this package together will require a reform project team of lawyers and economists, including both local and international experts.

Reform project managers should expect challenges on several fronts:

- They must understand the legal issues well enough to make informed judgments about the quality of the assessment study and the legal changes being proposed by an international expert in secured transactions law.
- They must supervise the interaction between the lawyers and the economists on the reform project team or supervise the business that supplies the lawyers and economists.
- They must be prepared to explain and defend the reform, throughout project preparation and later, to key stakeholders in the country – often in the absence of the experts on their reform project team.
- They must supervise the foreign and local reform project teams that will assist in this explanation and defense.

3.2. The assessment study

An assessment study is key to the success of the reform. It should identify legal barriers to using collateral. It should also distinguish problems in access to credit attributable to laws from those with other causes (political instability for example).

Some assessment studies simply list the legal problems in current law. That approach limits their effectiveness. A study that merely identifies a legal constraint – without explaining its economic impact – will be less convincing to key stakeholders. Assessment studies need to carefully explain to stakeholders the economic problems arising from the present legal framework, compare that to the potential economic impact of reform, and show that a solution is feasible within the country's legal and institutional framework.

Non-legal readers of the assessment study – economists, many local officials, local banks and businesses – are accustomed to thinking about constraints on access to credit that stem from economic cause, but may not immediately understand the potential economic impact of purely legal provisions, such as:

- Should the law require a precise description of the goods taken as collateral?
- Should the law permit the borrower to sell the collateral?
- Should the law provide for the automatic continuation of the security right in the proceeds of the sale or other disposition of the collateral?
- Should government tax claims have super priority?
- To keep non-legal readers engaged, the assessment study should explain as early as possible why technical details such as these can have an enormous impact on the effectiveness of the secured transactions system and thus on access to credit.

Legal readers – local practicing lawyers, notaries and government officials trained as lawyers – may have different needs and expectation. Stakeholders trained in the local law will typically have a general understanding of the importance of a framework for secured lending. But they also will often believe that their country already has such a framework. The assessment study must therefore convince these readers that the legal problems in access to credit are not just simple differences in approach but differences with great economic importance. Discussing the potential economic gain from reform is important because changing established laws and legal practices always incurs costs. Stakeholders may be more willing to accept that their country should pay those costs if they expect a large economic gain.

The question of economic gain from different legal alternatives weighs heavily on judicial decisions and can influence judicial rulings on constitutionality. So it can be helpful for legal readers if an assessment study explains the economic merits of different drafting solutions, giving estimates of the potential gains from different approaches. For example, "*this approach will exclude accounts receivable, which represent about 10% of business assets*."

An assessment study has four components:

- A legal diagnostic based on a preliminary examination of local law.
- Field interviews that investigate the effect of current law on access to credit.
- A legal analysis that tracks the causation from legal defect to observed characteristic of the credit market.
- An economic analysis of the likely impact of reform.

3.2.1. Legal diagnostic

The first step in the assessment study, an initial legal diagnostic of the existing laws governing secured transactions, will point to the questions that the reform project team should ask in the field interviews. This assessment requires help from both a local secured transactions lawyer and a foreign lawyer with expertise in secured transactions law (experience in World Bank-led reform projects assesses a need of typically 5-10 staff days).

The local lawyer should identify the fundamental secured transactions laws and related laws that affect their operation. These laws typically include the bankruptcy law, the organization of the judiciary and the enforcement procedure for the realization of collateral, the banking laws and regulation, and consumer protection laws. But the local lawyer should have enough expertise in the debt collection process to identify any additional laws that are relevant. For example, labour laws could prohibit the seizure of a minimum part of wages, property law the enforcement of a security over a collateral if it is an artisan's main labour tool, family law the eviction of any family with under-aged children, and customs law give priority to custom, tax or import duties-related debts over the claim of secured creditors on the collateral stored at the customs warehouse.

The local lawyer should also report the local view on the main problems in the debt collection system and options for reform. The local lawyer will rarely be able to identify all the problems in the underlying laws, however, because the local lawyer will typically have had no training in foreign legal systems that allow effective use of movable property as collateral. Once the local lawyer has found the laws and competent translations and submitted the local view on the source of problems, the diagnostic task therefore passes to the foreign lawyer.

The foreign lawyer needs to check the law for important potential problems in each stage of the secured transactions process – creation, priority, publicity, and enforcement of a security right. This initial assessment should cover all the material discussed in Part 4 of this study. The assessment should be sufficiently specific and understandable to enable someone who is not a secured transactions specialist lawyer to follow up.

Each reform project team will determine the organization of the assessment study in accordance with the particular case. Below is a recommended outline based on successful experience reported by the World Bank:

Box 14: Outline of the assessment study

- *Chapter 1. Economic impact of secured transactions* – Discuss the principles underlying the economic importance of secured transactions and the gap between the legal framework pre-reform and best practice. Estimate the potential economic gain to the country from reform.
- *Chapter 2. Legal issues* – Identify in detail each feature of the law that limits the use or impact of secured transactions at each stage in the process: creation, priority, publicity, and enforcement of a security right (see Part 4 of this study). Identify the causation link between that feature of the law and its economic consequences access to credit.
- *Chapter 3. sectorial study* – Set out the results of the field interviews and additional local data.
- *Chapter 4. The reform* – Discuss the main options for the reform.

Part of the above could be addressed in questionnaires covering the following two areas:

- Identifying the existing (pre-reform) secured transaction framework.
- Assessing the effectiveness of the law and practice for secured transaction in the country in terms of percentage of debt recovery in case of enforcement of security, speed and simplicity of enforcement process for the secured creditor.

Questionnaires can be answered by local correspondents either in short concise answers or through a grading system ranging from ☑ ☑ ☑ for a definitively yes to ☒ ☒ ☒ for a categorically no without forgetting **?** for uncertain. The grading system approach is easier to use for benchmarking or comparative purposes (essential in regional integration processes). A combination can also be used starting with the grading system and elaborating further where needed through concise notes.

Example of key to the grading system

Key	
☑☑☑	Yes
☑☑	Yes, but with some reservations
☒☒	No, but there are some mitigating factors in law or practice
☒☒☒	Categorical no
?	Uncertain

Identifying the existing secured transaction framework

- Does the security create a right which is proprietary in nature over the secured assets (collateral)? A security creates a proprietary right when (i) it offers secured lenders the ability to enforce their claim by requiring the collateral to be sold so that the proceeds can be used to repay the secured debt, and (ii) the rights under the security are effective against third parties claiming a right in the collateral.

- Can the security be granted by any person or is it restricted, for example, to registered merchants? What about consumers?

- Can the security be granted to any person or is it restricted, for example, to professional lenders? Are suppliers allowed to benefit of the same security rights as banks or are they restricted to a certain type of security only, for example, retention of title?

- Can the security secure any debt, including fluctuating debts and generally–described debts, to the extent such debt is determinable in monetary terms?

- Can the security cover all types of assets: movables and immovables, receivables and claims, etc., regardless of the form in which they can be granted by way of security: fluctuating pools of assets, After-acquired property, After-produced property, generally–described assets, etc.? Property whose granting by way of security is commonly prohibited in statutes should be ignored. This type of property usually includes:

  - Property removed from the course of dealing, such as historic or artistic treasures.

  - Property of individuals which is deemed a minimum necessity of life of basic tools of trade.

  - Claims that are strictly personal in nature, such as wages or alimony.

- Does the security, where properly perfected, give priority over all other creditors?

- Does the law clearly define the manner of creating a security right? In particular:

  - Are there formalities required for creation or stamping or registration of security? For example, do notarized debts require a security right granted in consideration thereto to be equally notarized?

  - Can a security be simply created? For example, are there any administrative requirements for registration, such as production of documents or verification of information?

  - How quick is the process required for the creation of a security? Please use the following grading key:

Key	
☑☑☑	Within one day
☑☑	Two to three working days
☒☒	Four to five working days
☒☒☒	Over five working days

- Is the proprietary right over the collateral conferred by the security to the secured creditor effective through a publicly searchable registration system that would allow any person dealing with the collateral to find out about the security?

- Are the costs of creating a security right over movables low enough so as not to dissuade SMEs or do the statutory costs conceal a hidden tax? For example, a €100 fee would be acceptable in a large transaction but could be dissuasive for micro or SME finance.

- Does the existing secured transaction law allow for the creation of non-possessory security that permits, without impairing the creditor's proprietary right, the grantor to use the collateral:

  - In the ordinary course of business, for example sell collateral that is secured as a fluctuating pool of property and replace it with new identical property.

  - As part of a manufacturing that leads to the transformation of collateral or its incorporation into other assets, for example, raw materials being manufactured.

- Can the collateral be described generally as opposed to an obligation to specifically identify each property included in the collateral?

- Can the collateral include After-acquired and After-produced property?

- Can the security be taken over a fluctuating pool of assets?

- Can the secured debt be described generally? For example, all amounts due to a supplier for goods supplied.

- Can a future debt be secured, including:

  - Debts arising out of contracts executed but where the consideration for which the debt arises is not delivered yet, for example, the goods for which price is due are not yet shipped.

  - Debts arising out of contracts not yet concluded.

- Can the debt be in a foreign currency? Please do not take into account when drafting your answer exchange control restrictions.

- Can a fluctuating pool of debt be secured? For example, the fluctuating balance of a trading current account.

- Do parties have latitude to agree on covenants in their facility agreement? For example, cross–default, material adverse change, pari passu, negative security rights, inspection rights of borrower's inventory, etc.

- Are subsequent security rights allowed over the same collateral?

- Is a person acquiring title to the collateral without knowing of the prior existence of the security right protected vis-à-vis the secured creditor? If a publicly searchable registration system is available for the perfection of security, would a third party still be entitled to claim good faith when acquiring title over the secured collateral?

Assessing from a practical perspective the effectiveness of the existing secured transaction law

Assume a default under a local loan of €75,000 to a privately owned manufacturing limited company. The default is due to cash flow problems and the validity of the loan agreement cannot be challenged on grounds of validity or otherwise. The lender has security over equipment used in the debtor's manufacturing process and stored on its premises as well as over inventory.

- How can the lender verify that the security right is valid and enforceable? For example, what evidence is needed of the creation or stamping or registration of the security to be enforced?

- What evidence is needed to ascertain the debtor's failure to pay and hence the right to enforce the security, for example, is a delivery of a failure notice by a process server required?
- What steps are needed to commence the enforcement procedure? Is there a minimum statutory period imposed for the duration of each step?
- Can the lender choose to enforce the security out of court by selling the collateral himself or at least by exercising some control as to how the sale occurs?
- Assume that there is a ready market for the equipment and inventory covered by the security, is the price likely to be obtained through the enforcement procedure be at or near to market value? If not, what is the likely level as a percentage of market price?
- What costs will be incurred on enforcement? Will they be recoverable as part of the lender's claim?
- How long is enforcement likely to take from start to receipt of sale proceeds?
- In what way can the debtor delay or otherwise obstruct the enforcement process? Can the lender take any steps to prevent this from happening?
- What will be included in the collateral on which enforcement is sought?
  - For example, if one of the machines included in the security was replaced over the life of the security, will the new machine be included in the collateral?
  - If an additional machine was purchased, will that new machine be included in the collateral?
  - If another machine was sold, does the security right extend to the proceeds of sale?
  - If part of the inventory is sold in the normal course of business and new inventory is added, would it be included in the collateral?
- Could claims from lien holders or competing claimants affect the enforcing lender's rights of recovery?
  - For example, if the defaulting borrower owed tax arrears, would the tax office have a preferential claim over the collateral?
  - Do employees enjoy a preferential claim over all or part of their salary?
  - Do shareholders enjoy a preferential claim?
  - Do judgment creditors, with or without an enforceable judgment, enjoy a preferential claim? Does the date of the judgment compared to the date of the creation or of perfection of the security right matters?
  - Does local law provide for other liens, retention rights or other priority rights that could defeat the lender's proprietary claim over the collateral?
- Would any of the answers to the above questions differ if the debtor becomes insolvent and files for bankruptcy:
  - Prior to the lender's starting the enforcement process?
  - After the lender's starting the enforcement process but before completion of enforcement?
- Would any of the answers to the above questions differ:
  - If the collateral consisted of property other than equipment or inventory, for example a building (other than residential apartment) or receivables?

- If the debtor were a state–owned company?
- If the lender were a foreign bank?

- What does the lender need to know about how the courts and other legal institutions (for example court enforcement officers) operate in the country where the assessment is conducted which has an impact on the enforcement process, for example are there specific commercial courts to handle commercial matters?
- Is the corruptibility of the court of court officials likely to be an issue?

Based on an IFC model, this study proposes in Annex 1 a sample questionnaire that could be used at the beginning of the reform project. IFC also recommends using the sample two years after the completion of the reform project to assess the project impact.

3.2.2. Field interviews

After achieving an initial legal diagnostic, the reform project team should undertake a mission of 5-10 staff days (estimation based on World Bank experience) to interview private businesses, including banks, non-bank lenders, and borrowers, and the lawyers who represent them. These interviews will enable the reform project team to discuss with the stakeholders the preliminary findings set out in the initial legal diagnostic and identify their needs and expectations by sector. It is recommended that this stage of the project combines a legal and an economic expertise.

The field interviews should be aimed primarily at understanding the broader context in which secured transactions take place – whether and how much actual practice corresponds with the law – and secondarily at collecting data. The most important data are those required for the economic analysis – the terms of loans (interest rates, maturities, credit limits, collateral requirements), which should be collected from all lenders and checked with borrowers when possible.

Private businesses generally give more accurate information on secured transactions than do state-owned businesses. The reason is that the government often explicitly or implicitly guarantees the debt of state-owned businesses. Consequently, private banks will sometimes accept pledges of movable property from a state-owned business in the belief that the state will pay the debt if the business defaults. With a possible state guarantee, a pledge by such a business gives little information about whether the collateral can actually be repossessed and sold.

Finally, the reform project team should visit and examine the registry for security rights if it exists. This visit can produce important information on how the registry operates and whether the law of secured transactions is actually being used.

Banks and non-bank financial institutions

The reform project team must always interview banks, since they are the main providers of credit to the registered business sector. But it should also interview leasing companies and microfinance institutions.

Banks. When interviewing banks, the reform project team should meet with the heads of the credit and risk departments. Credit officers want to lend, and they know what loans are actually being made. Meanwhile, risk departments, often in the position of restraining credit officers, may lack complete information about what credit officers are doing. Bank lawyers also have experience in debt collection, and the reform project team should ask about that experience in detail. If the reform project team is told that certain loans are not made because of bank policy, it should try to see the person who makes that policy.

Banks can be expected to give a good account of how the legal framework for real estate operates. Since they have collection departments, they can, more readily than most non-bank lenders and sellers on credit, start proceedings to attach the real estate holdings of a defaulting borrower. However, when it comes to using movable property as collateral, the reform project team should cross-check the responses of banks with those of borrowers to gain a good understanding of the legal and practical limits. For example, if banks say they will finance any lease for any kind of equipment, the reform project team should ask businesses about their experience in financing equipment with leasing, then discuss their responses with the banks that are interviewed.

Leasing companies. Interviews of leasing companies should focus on how they repossess leasehold collateral. Is a court procedure necessary or not?

As an interview progresses, the reform project team should ask how the leasing company finances itself. The best way is to inquire whether the leases can serve as collateral for loans. An important question is whether the leasing company is owned by a bank. In most lax systems of supervision and regulation, ownership by a bank will give a leasing company nearly automatic access to loans financed by deposits.

Microfinance institutions. The reform project team should ask microfinance institutions how they collect their loans which are generally unsecured. To the extent microfinance lenders take collateral in any formal way (lease, registered pledge, registered mortgage), the reform project team should find out how such collateral is taken and later enforced. Many microlenders, like banks, offer secured as well as unsecured loans.

Finally, the reform project team should ask these lenders for their rate of non-performing loans and find out whether their portfolio of these loans can serve as collateral with licensed banks or on the capital market.

Sellers on credit

Motor vehicle dealers. The World Bank's experience in microfinance lending shows that cars are generally highly rated collateral, with trucks and buses close behind. The underlying property is valuable, standard in design, and easy to resell. Even obsolete legal frameworks for secured lending permit repossession and sale of a motor vehicle. And if the lender or seller on credit uses any title retention device (financial lease, sale with retention of title), the car can be privately repossessed whenever the secured party finds it.

The World Bank recommends, when interviewing dealers, that the reform project team asks whether they sell on credit themselves, originate credit-sale contracts that are taken over by a finance company, or rely on banks and finance companies. What are the terms of the loans? Does the dealer or the bank require an additional security right against real estate or the co-signature of someone who owns real estate – or require that the car purchaser own real estate in order to qualify for financing? In these cases, lenders may not be relying on the automobile for collateral, even though they take a security right in it. They may instead be relying on the ability to attach real estate if the borrower defaults.

Equipment dealers. Equipment dealers provide an important cross-check on the views of banks about collateral. These dealers rarely have the staff to maintain extensive collection systems for seizing real estate. Nor do they have the information advantage of banks, which can inspect borrowers' bank accounts and loan portfolios directly. Dealers therefore depend much more on the ability to repossess equipment and can often give a more accurate account of the legal framework for movable collateral.

The reform project team should use the findings from interviews of equipment dealers in its interviews with banks and organizations of borrowers and of lenders. It should cross-check constantly, asking the banks for comments on what the equipment dealers say and, where there are substantial disagreements, asking for a follow-up interview. For example, if Dealer A says that banks always wants the borrower to own real estate and Bank B says that it never asks for real estate, the reform project team should ask Bank B to recommend a dealer that could discuss these policies more along the lines of the bank's account.

An important constraint on any dealer's ability to sell on credit is its own access to credit. So the interviews should determine whether dealers can use credit-sale contracts or inventories of equipment or parts as collateral to expand their access to working capital and to refinance their credit sales. Can new equipment serve as collateral, and if so, is credit advanced to the dealer by the manufacturer or by a bank? Can the dealer use its stock of used machines as collateral, or only new machines? Many dealers get equipment on consignment from manufacturers that are in effect financing the dealers' inventory of new equipment.

The registry

The reform project team should go to the security right registry to find out how it operates. What type of computer equipment, operating system, and database system does it use? How is the registry administered? In particular, how is it funded, and who gets the duties paid for filing? That information will be important in designing a reform, because registries that stand to lose revenues can often be strong opponents of reform.

The reform project team should see what data the registry collects. A refusal by the registry to give the reform project team data would be revealing of its policy on public access to information and, more generally, of the quality of the system.

If data are available, the reform project team should review them and question any anomalies. For example, the World Bank reported that the Ukrainian registry seemed to be operating well, was technically well designed, and had a large and steadily growing number of filings. But further inquiry found that the filings consisted entirely of tax liens and car loans. The tax liens were filed because the law compelled the government to do so. The filed notices of “pledges” for car loans were just a cover for a parallel automobile registration system using retention of title for the sale of cars on credit.

If the data show that no security rights are being filed, then the reform project team should conclude that the system is not being used, no matter what it is told about possibilities and practices under the law.

The reform project team should ask precise questions about public access: Are there any restrictions on who can look, and when? Can people conduct searches themselves, or must they have a registry employee do so? Is there remote public access? If so, how does it work? Is Internet access available or contemplated?

3.2.3. Outcome of the assessment study and the field interviews

Based on the assessment study, the field interviews will generate the data on terms for secured and unsecured loans needed for the diagnostic work. These data include:

- Spreads over mortgage rates for loans secured by small real estate holdings, movable property, and unsecured loans.
- Customary loan limits on debt service relative to cash flow.
- Terms of car loans compared with those of unsecured loans for similar borrowers.
- Exact terms of mortgage loans, car loans, and personal loans.
- Loan-value ratios for vehicles compared with those for other equipment.

This data will be important in calculating the potential overall gain from reform. Data on the ratio of private credit to GDP suggest the possible impact of collateral reform. But because these ratios depend on many financial sector and macroeconomic characteristics, they do not by themselves establish the relationship between legal problems, limited use of collateral, and limited access to credit. Data on private credit should be checked with the central bank.

3.2.4. Preparing and presenting the draft law

In preparing the draft law, the project moves from the assessment stage to the actual reform. The drafting of the law will require an expanding circle of local lawyers to check that the proposed reform is consistent with local law and to explain local law. When derogations of local laws are required for consistency, local lawyers will be best equipped to identify all conflicting laws and warn about public policy issues that must be handled in the derogation.

The content of the law is fundamental to the reform (for the key elements of a reformed law, including provisions for the filing archive, see Part 4 of the study). To be economically effective, the law must remove the legal restraints on the use of collateral. And to help build consensus in support of the reform, the law must assure stakeholders that it will alleviate their problems.

3.2.5. Timing of presentation

The best time to present the draft law is shortly after the government and stakeholders review the assessment study. Experienced consultants report that the assessment study typically produces a great deal of agreement, especially flowing from the analysis of legal problems and the field interviews. The law is another matter. The draft forces stakeholders to focus on what must be changed to solve the problems. Sharp questions and opposition should be expected.

3.2.6. Drafting committee

The reform project team should prepare a draft of the law before going to the drafting committee.

The drafting committee can serve as a forum for the core group of local lawyers to continue working through details of the law. It also provides a place for lawyers representing stakeholders and the government to raise concerns or listen to discussions of issues. And it provides a training ground for the local lawyers whom the reform project will need to explain issues to their organizations and counterparts. The committee's constitution should be flexible, including members sent at the request of the government and private stakeholders as well as those chosen by the reform project team.

The role of the drafting committee will depend on the project and the position of the sponsoring international financial organization in the law reform process. Where the World Bank or the International Monetary Fund places the full weight of conditionality on passage of a satisfactory law, the drafting committee may play a secondary role. Where donors must persuade the government to move ahead with reform without the carrot of a large loan or the stick of conditionality, drafting committees can serve as venues for resolving problems in the presence of government officials and key legislators, building confidence in the viability of the proposed reform.

3.2.7. Commentaries

The draft can be complex and often change fundamental principles of secured transactions in the existing system. Detailed commentaries are essential to answer the legitimate questions by all stakeholders, especially if the project team is not available to attend all draft review sessions.

Commentaries can help preserve vital elements of a draft law. Experience shows that those reviewing any law tend to strike out or simplify language that seems redundant or contrary to local legal practice. Without good commentaries, reviewers might eliminate legal passages with important economic impact. World Bank consultants report an experience in Uzbekistan, which received three draft laws in 10 years under different international organization-funded projects, Central Bank staff carefully reconstructed each law in a matrix showing parallel clauses. Handwritten comments amounting to “Why?” or “Not consistent with Uzbek law” were sprinkled everywhere. The few remaining points of agreement would have had no economic impact. Good commentaries avoid this reaction by explaining the relevance of each important passage.

Proposals for speeding up enforcement, whether or not out-of-court, should be expected to be the most contentious part of the legal reform. Some opposition can be eliminated by separating the enforcement of consensual security rights from other legal actions that result in the seizure and sale of property. Equally important are the commentaries and repeated proofs of the economic cost of slower enforcement systems. Reform projects should beware compromises as they can be fatal to the economic impact of the law. Experience shows that even a law that clearly directs the judge to order immediate enforcement when the debtor fails to pay can lead to a process long enough to deprive property of much of its value as collateral.

3.2.8. Building public awareness and mobilizing support

Winning acceptance of a new law of secured transactions is not simple. The small number of successful reforms shows how difficult they are to achieve and implement. Reform projects that proved to be successful have systematically built on the constituencies that support reform.

It is important to quickly identify the relevant stakeholders during the assessment stage. All the stakeholders need to understand how the law will help them. Much of this discussion ideally will appear in the assessment study. But the dialogue with stakeholders should begin when the reform project team discusses the assessment study with those who contributed to it during the first round of interviews. And it should continue when the draft law is presented to these groups for discussion and review. Those stakeholders typically include:

Private lenders and sellers on credit

It is important that the assessment study identifies each group of stakeholders and provides a section on how the law will help each of those groups. To the drafters of the study used to generalization, the interests of some of those groups might seem redundant, but it will not seem so to these groups. Even after the study is circulating, brief notes targeting key groups can be very helpful.

Comparative studies can often be persuasive. A presentation to Turkish farmers could contrast the financing of wheat farming in the United States with that in Turkey. One in Nicaragua could compare the use of coffee as collateral in that country with the use of the same coffee as collateral after it was exported to the United States. World Bank consultants report a clever idea by one donor who sent a Bulgarian television crew to interview American car and equipment dealers on their sale terms. American dealers reacted incredulously to the suggestion that someone wanting to buy a car on credit would have to have title to a house. This technique was far more effective than a written analysis in raising questions about prevailing practice in Bulgaria.

Debtors and borrowers

While lenders can be expected to support the reform for obvious reasons, experience shows that well-informed debtors and borrowers show strong support for it as well. Borrowers would do so because they have such limited access to credit that the prospect of getting more credit once the reform is implemented outweighs the prospect of a more stringent enforcement procedure on the debt they owe.

Sometimes, though, the project manager must deal with important exceptions. In countries where politically powerful people have accumulated many bad debts owed to State-owned lenders, those debtors may not want to see the debt collection system strengthened. A possible solution could be to exempt from the new law the outstanding debt so that the debt collection system applies only to new debt.

Countries undergoing financial crises are likely to generate a strong opposition by insolvent borrowers to any stronger debt collection system. This opposition will be transmitted to the government and the sponsoring donor. Moreover, commercial banks will be allowed to roll-over their loans to disguise those in default. In these situations, even the banks may not strongly support the strengthening of the collection system. Only two paths are politically feasible: exempting the outstanding debt from the reform or waiting until after the inevitable recapitalization of the banks.

Opposition from private lenders may relate to the prospect of more competition. Sometimes this opposition comes from banks, which are comfortable with high spreads and smaller credit volumes and uninterested in more competition, especially from non-bank lenders. Sometimes the opposition comes from micro-lenders, which see the ability to securitize unsecured loans not as a benefit that will reduce their costs, but as a threat that will increase micro-lending by other financial institutions.

The government

Governments do not always support secured transactions reform. The reason for this varies. Sometimes it is general insensitivity to the needs of the private sector. Sometimes it is a political stake in government-funded lending programs and guarantees, or a desire to protect state-run enterprises or debtors of state lenders from more effective debt collection. More frequently, the lack of government support arises from a failure to understand the logic of the reform or from disbelief that something the government has worried about so much – limits on access to credit – could be explained by legal problems it has not worried about at all.

Special problems sometimes arise with projects run through the ministry of justice. Given enough lead time, working with the ministry of justice as a counterpart appears to have succeeded in some reforms – though lack of evaluations of these reforms makes a final judgment difficult. Justice ministries often do not want to take the lead on what they see as economic reform laws, out of concern that it will open them to attack from the economic ministries on matters of substance and jurisdiction. And justice ministries sometimes have vested interests in retaining control over obsolete registration systems that generate fees. Better counterparts tend to be the economic ministries, the banking regulators, or the central bank.

This general guidance is no substitute for careful collaboration among the project manager, the foreign experts, and the local reform project team in selecting the counterpart that will champion the reform.

As difficult as the government may be to work with, in the end passing laws is a monopoly of the government. If no one in the government champions the reform, the law will not be presented and the reform will not take place.

Lawyers and notaries

Lawyers and notaries sometimes oppose the reform. Experience suggests that their opposition is rarely based on narrow self-interest, despite the prospect of lower fees. Most professionals see that it does little good to charge a high fee for filing a security right if no lender will use the instrument.

Most important in winning the support of this group is persuading its members that the proposed legal changes are consistent with the main body of the country's laws and likely to yield a large economic benefit. A good assessment study and clear commentaries accompanying the draft law – produced through close collaboration among good local lawyers, foreign legal experts, and economists – are crucial. The greater the association of local lawyers in the reform project, the easier it becomes to win support among lawyers and notaries.

The legislature

Relations with a country's legislature – its parliament – present both opportunities and challenges. Parliamentary committees dealing with relevant issues are usually quick to see the need for the reform and can become valuable allies. But multilateral institutions face constraints in their direct dealings with a parliament because of their understandings with the government, which often does not like these institutions to deal directly with the parliament. However, some donors have consultative arrangements in place that include the parliament, and these can serve as neutral territory for explaining proposals.

Even when the government supports the law, it often cannot defend it before the parliament because it lacks staff with the necessary skills or understanding. The project therefore needs resources for presenting and responding to this body. This is a step often neglected by multilateral institutions, used to dealing only with the government. Such support can keep otherwise well-meaning legislators from simply deleting parts of a reform law because of a failure to understand their relationship with the overall reform.

The central bank or banking regulator

Improving credit conditions can be expected to bring a central bank or banking regulator to show keen interest. Yet in the countries that have undertaken secured transactions reform, regulators have never initiated the reform program, though they have sometimes strongly supported it. This lack of a clear pattern of support stems in part from the same factors that lead governmental attitudes.

Project managers should not take the support of the central bank or banking regulator for granted, should take the necessary steps to get it, and should have a plan for working around opposition if it should develop.

In summary of this chapter on implementing the reform, it is key that the reform be owned by the relevant government agencies (justice and/or economy and finance) in close cooperation with other departments and institutions, in particular the monetary authorities. A working group representing the main stakeholders has to be set up at the outset. The role of the working group is to:

- Represent the interests of the stakeholders in the private and public sector who are, or could be, affected by the reform (commercial banks, tax authorities, central bank and financial regulators, notaries, insurance companies, enterprises), and

- Involve those stakeholders in the reform process to ensure that the reform will support and advance their respective activities or have no undesired negative effects, and that such reform is understood, publicized and capable of being used from the very beginning.

Active participation of all the identified stakeholders is very important to the success of the reform.

3.3. Monitoring reform and impact study

It is essential for the success of any secured transactions reform program to measure the impact of the reform once implemented. The monitoring of the project and the performance will serve as a reporting tool to the implementing institution, donors, the government, and main stakeholders.

This study draws on the experience of IFC which has developed a monitoring and evaluation methodology that could prove to be particularly helpful in reform projects.

The project team needs to determine during the design phase of the project the indicators it shall be using to measure the intended results. There are many outcomes and impacts that can be measured in a reform project.

Output indicators aim to measure the magnitude of the activities produced directly by the project team. These indicators permit to measure the impact, which is the desired final change and should be associated with the development impact, which includes higher credit, lower cost, greater income and economic growth. Often, the correlation between the project outputs and the project impact (economic growth, higher productivity, increased employment, etc.) is not easy to demonstrate. Whatever the difficulty, the main objective should be to improve access to credit by establishing a new secured transactions legal framework and a collateral registry.

3.3.1. When to measure the impact?

There are three points in time where a measurement of performance indicators should be made throughout the reform project.

- The first stage is at the diagnostic phase when the assessment of the existing secured transactions system is being made.

- The second measurement exercise should occur when results can or should be expected (e.g. 6 months) during the implementation of the project and after the project has been completed. This measurement is intended to determine whether the reform introduced has actually resulted in improvements.

- The third measurement period takes place in the immediate years after the project was completed and the measurement is usually done by the owner of the reform or client.

During the diagnosis or design phase, the project team will need to ensure that performance is measured from the very inception of the initiative to guarantee that performance targets are met. Without accurately recording data, the project team will not be able to determine whether the introduction of a new secured transactions regime has met its goals. To determine whether a reform process has been successful, it is necessary to conduct an evaluation, essentially taking “before” and “after” snapshots of performance. To do this, the diagnostic phase should include a benchmarking exercise to capture performance indicators prior to the process design. Normally, the reform team should undertake baseline surveys (see Annex 1) in the design phase to obtain statistics regarding the indicators provided in the previous tables.

3.3.2. How to measure the impact?

Successful measurement depends on the quality of data collected. Data should be collected in a consistent manner using agreed definitions and procedures, and stored in appropriate computer databases to facilitate data access, analysis and reporting.

Program records

The project teams should maintain complete and accurate records. This should include data on the characteristics of the organizations receiving advisory services for the reform. It should also include data on particular projects, including the type of activity (assessment, advisory services, training and information dissemination), participants, service providers, date of initiation and completion, and budget expenditures.

Surveys

As noted above, the project teams will need to conduct a variety of surveys to collect requisite data. To ensure the quality of data, the following procedures are recommended:

- **Questionnaires**. Project managers should use instruments that contain questions needed to obtain data required for relevant indicators. Questions should be worded in the same manner with any translations checked to ensure that meanings have not been altered inadvertently.

- **Sampling**. The goal is to have a sample that is representative of the relevant sector, operation or category of professionals and therefore can be used to make valid generalizations. Project managers should survey a random sample of organizations drawn from the appropriate set of program participants or the target category as a whole. A random sample is where each entity in the sample frame has a known and independent probability of being selected for the sample. The size of the sample should be large enough to provide sufficient statistical power. Although there are no formal standards for statistical power, IFC norms recommend that project teams should aim to draw a sample that would provide a power of 0.8 or greater.

- **Administration**. Given the nature of the information sought, most surveys should be administered in person (as opposed to mail or telephone) under a strict confidentiality. All survey should seek to achieve a high response rate (IFC recommends at least 60%) to reduce potential response bias.

- **Data entry**. The reform project team should establish specific procedures for dealing with completed surveys. The quality of data entry should be verified by checking all or a sample of questionnaires for accuracy and by carefully examining data for responses that are not consistent. Original copies of written questionnaires should be kept on file.

Box 15: Summary of reform project stages and deliverables

1. Identification Phase

- Official request from country to provide support in secured transactions reform.

2. Project Preparation

- Analysis of the request and decision whether to intervene or not.
- Secure funding for diagnostic.
- Organization of a team and plans for the diagnostic field visit.

3. Diagnostic Phase

- Field visit and interviews.
- Survey, collection of baseline data.
- Preparation of a report with recommendations for reform (Concept paper).

4. Implementation Phase

- Secure funding for implementation of reforms.
- Identify government counterpart to sponsor law reform and registry development.
- Sign Memorandum of Understanding (MOU) with State.
- Put together implementation team.
- Create a working group composed of representatives of different stakeholders to work on the implementation of the project.
- Conduct as many field visits as needed.
- Prepare draft legislation, vet it with a working group and implementing decree and/or regulations, and deliver to government counterpart for introduction to adoption processes.
- Determine organizational and physical placement and configuration of registry.
- Determine number and types of procurements to be done, such as application software, hardware, office equipment, ISP services, data center services, IT maintenance, and office space.
- Design and develop specifications for procurement of software for the registry.
- Conduct awareness raising events.
- Advise on other procurements such as office space and equipment for the secured transactions registry.
- Develop job descriptions and selection standards for registry staff.
- Conduct training for registry staff and other stakeholders such as creditors or users, judges, execution officers, government officials and private sector.
- Design or procure the software for the registry.
- Placement of the registry.
- Produce a Manual of Procedures for the operation of the registry and a user guide for end users.
- Test and deploy registry technology system.

5. Official Start of the Registry

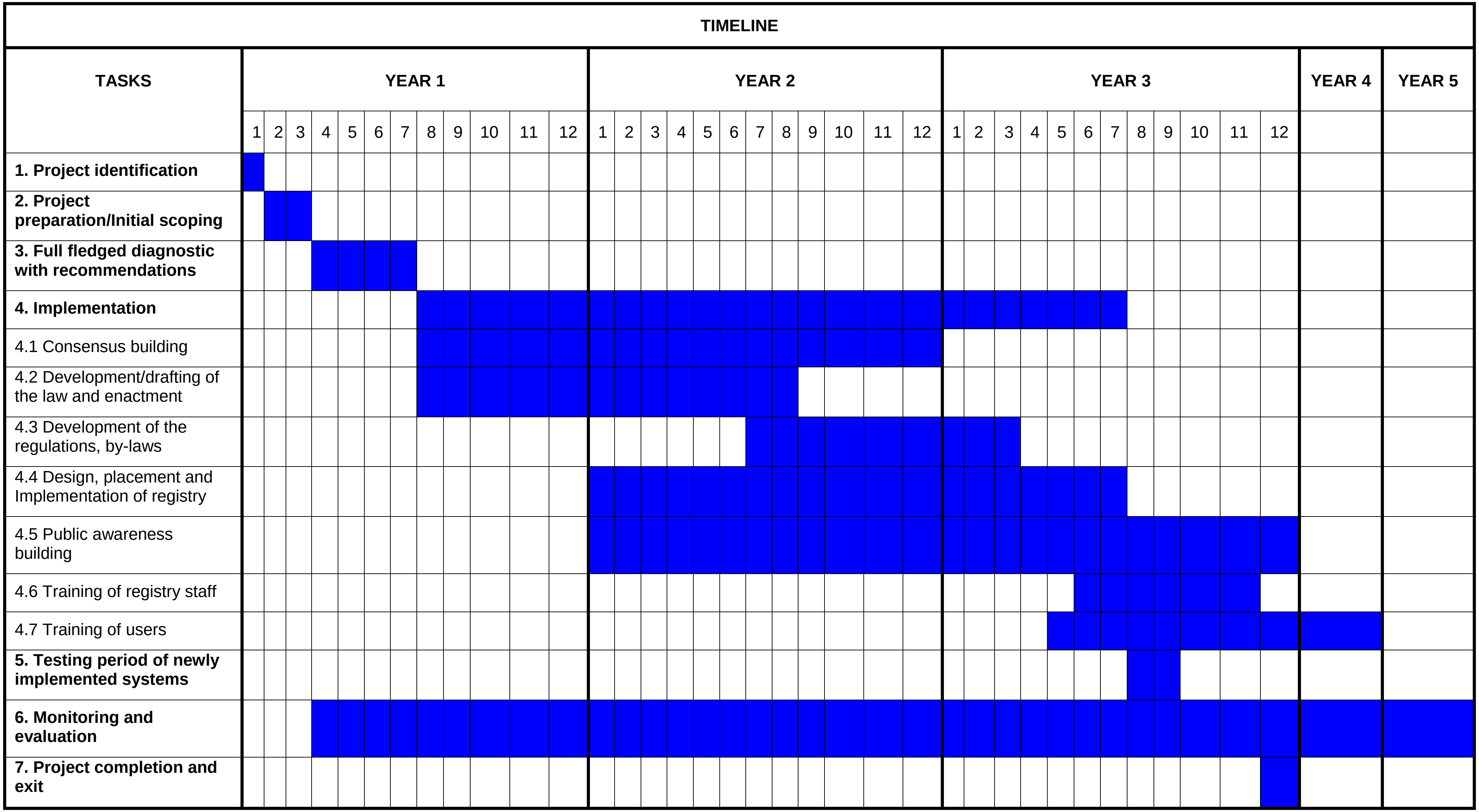
- Registry officially inaugurated.

6. Monitoring and Evaluation and Follow Up

- Impact assessment reports at least every 6 months after the completion of the project. Done by registry staff.
- Periodic follow up with client/counterpart.

Source: International Finance Corporation.

Box 16: Timeline of reform project stages and deliverables



Source: IFC.

4. MAJOR COMPONENTS OF A MODERN SECURED TRANSACTIONS LEGAL FRAMEWORK

Box 17: Key features of a modern secured transactions framework – A summary

Scope. A secured transactions law meets its objectives in fostering credit, and therefore growth, when it broadly defines the scope of permissible collateral to include tangible and intangible property of any nature, assets that do not yet exist or are owned by the debtor (future assets), and a changing pool of assets. A single, unitary concept of security right should be adopted for granting a proprietary right in any movable property from the debtor to the creditor in order to secure an obligation of the debtor. Moreover, the collateral must be described generally and generically to allow the possibility of creating security rights in future assets and fluctuating assets, a prerequisite for modern inventory and receivables financing. Requiring more specific descriptions prevents future and fluctuating assets from being used as collateral, and is cumbersome even for existing assets that are not uniquely identifiable (e.g., inventory).

Creation of security rights. Formal requirements for creating security rights should be kept minimal. Modern secured transactions laws recognize parties' ability to create a security right as a proprietary right in movable collateral by agreement. Written agreement signed by debtor and identifying the collateral and the secured obligation should be sufficient. No special terminology, forms, or notarization should be required. Parties should have the freedom to address through the security agreement all matters relating to their relationship, including defining warranties and covenants, events of default, and remedies. Importantly, anyone may give security in movables and any person may take security in movables. Security over future assets or a changing pool of assets may be created by agreement without the need for any further acts.

Priority rules. Under modern secured transactions laws, a valid and enforceable security right does not achieve its priority status against third parties unless it has been made effective by either filing a notice in the secured transactions registry or by taking possession or control of the collateral. When several claims secured by the same collateral have all been perfected, priority rules establish the order in which such claims are to be satisfied from collateral proceeds when the debtor defaults.

Priority rules must be clear and precise so that a creditor and other persons dealing with the debtor can determine with a high degree of certainty the legal risks associated with granting secured credit. Priority rules generally consist of a basic rule of "first in time, first in priority". Creditors holding non-consensual liens in the collateral by virtue of a statute or judicial process (e.g., the tax authority, a judgment lien holder, holder of a statutory lien, or insolvency administrators) should be subject to the same "first in time, first in priority" rule.

Centralized publicity system. A key feature of a modern secured transactions law is an efficient centralized registration system. It serves two functions: (1) it notifies third parties of the existence of the security right and (2) it establishes the priority status of a security right based on the date of registration. Unlike title (ownership) registries such as a real estate registry, a secured transactions registration system does not create or transfer property rights. It merely performs an administrative function. Registry officials should not be responsible for (nor should they have the authority to determine) the authenticity, accuracy or validity of the information provided in the registration document. Efficient publicity machinery should feature a centralized registration system for all movable collateral, require minimum registration information (identification of the debtor and the creditor and a general or specific description of the collateral should suffice) with no underlying documents, prohibit substantive review by registry officials, offer broad access to the information and, to the extent possible, utilize an electronic system that enables speedy registration and information retrieval.

Enforcement. Speedy, effective, and inexpensive enforcement mechanisms are essential to realizing security rights. Enforcement is most effective when parties can agree on rights and remedies upon default, including seizure and sale of the collateral outside the judicial process. Reasonable safeguards against creditor misbehaviour should be adopted to ensure that self-help remedies are exercised peacefully and that commercially fair value is obtained through private sale of the collateral. When the seizure and disposition of the collateral does call for judicial intervention, expedited summary legal proceedings should limit judicial findings to the existence of agreement granting the security right and of an event of default.

4.1. Scope

This part of the study examines the overall scope of a modern secured transactions legal framework. It is divided into the following topics:

- Parties.
- Obligations.
- Collateral.
- Types of transaction.

For guidance purposes, the Principles for an efficient secured transactions law stated in Part 2 above that are relevant to this part of a secured transaction law state:

> "The law should allow the utilisation of the full value of as broad a range of assets as possible to support credit in the widest possible array of secured transactions".
>
> "The law should recognize party autonomy so as to accommodate new and evolving forms of secured transactions".

4.1.1. Parties

There are two types of parties to a security agreement: one will be the grantor, who can be the **debtor**, that is the person who obtains credit or finance, or not: there are cases where a person provides a security right over its assets to secure the borrowing or credit of another person – the grantor in that case is sometimes known as a guarantor or surety (French *caution réelle*). There can be several grantors for the same transactions, acting jointly or severally. The other is the secured creditor, that is the lender or financier (sometimes referred to as the 'creditor') who provides the loan or credit and who receives the benefit of the security right of assets. There can be several security rights for the same transaction. Secured parties can organize themselves in a syndicate and appoint someone (a secured creditor or a third party) to represent the secured parties (generally referred to as an agent or a trustee).

All of the above terms (or their equivalents) should be defined by the secured transaction law.

A secured transaction law does not normally place any restriction on who might be a secured creditor. Thus a secured creditor may be a bank, non-bank financial institution, private money lender, supplier of goods or services on credit, corporation, individual, family member or otherwise. It might seek to confine the range of persons to enterprises (a person in business, be that person a natural person or a legal person) or not impose any such restrictions. The issue is influenced by policy.

This raises the issue of the position of 'consumer transactions' in relation to a secured transaction law. A consumer transaction, in relation to credit and security, might be best described as a credit/secured transaction that is not made for business purposes. A business purpose is sometimes determined by having regard to the subject matter of the transaction. Thus, for example, if a person who conducts a business agrees to purchase goods for the household of that person on credit, that would be a consumer transaction because, although the person is a business person, the purpose and subject matter of the transaction is not one for business purposes.

Laws have been developed in many countries to provide some protection to this category of transaction. These laws centre upon contracts generally and include credit contracts and security contracts.

These laws (generally referred to as consumer protection laws) usually impose a number of terms or conditions that must be fulfilled before certain types of contracts (for example, a loan agreement or a security contract) will be considered valid. Examples of such conditions or terms are that the contract must be written in a particular way (plain language or hand-written acknowledgement), that the contract must be explained to the borrower/grantor by an independent professional third party (usually a lawyer or a notary) who must certify that the borrower/grantor appeared to understand the contract, that the consumer is entitled to cancel the contract within a specified 'cooling off' period, that in the event of default certain conditions must be fulfilled before any enforcement action may be commenced, that the borrower must have time to remedy any default and have the contract reinstated and so forth.

Policy wise, it is recommended that a secured transaction law covers ‘consumers’ and is not confined to persons in business. To exclude ‘consumer credit transactions’ from the ambit of the secured transaction law could mean that a significant part of the community is denied credit and denied secured credit. However, if the secured transaction law does embrace consumer secured credit transactions, it is important to recognise the need for an appropriate ‘consumer protection’ law.

Summary: A decision will need to be made on the range of parties to whom a secured transaction law will apply. It is recommended that there should be no restriction on who might be a secured creditor. As regards a grantor, the choice is:

- Confine the law to corporations.
- Confine it to business persons or enterprise.
- Let the law apply to everyone.

4.1.2. Obligations

The need for an underlying secured debt – The accessory link

The only reason for taking a security right is to lessen the risk against non payment of a debt arising from a loan or other form of credit. There must, therefore, be an underlying debt or money obligation that is connected with the creation of a security right. In a simple case, the grantor of a security right must have a debt or money obligation with the creditor. In the case of a third party grantor (*caution réelle*) who gives a security right, the guarantor must be liable to the secured creditor for the debt or money obligation for which a borrower or debtor is liable to the creditor.

The secured transaction law should provide that a security right is or becomes invalid or is of no effect in the absence of such a money obligation. This is generally referred to as the accessory link.

The obligation may not, initially, appear to be a money obligation. A security right might be taken, for example, to secure the performance of a contract that does not involve the payment of money (for example, a contract for the supply of goods). However, a breach of such a contract (for example, the failure to supply the goods) will normally give rise to a claim for damages that ultimately becomes a debt or money obligation. It is that prospective debt or money obligation for which the security right is security.

Future debt

The majority of secured transactions will involve a debt or money obligation that exists at or immediately *after* the security right is created. But the law should also take account of debt or money obligations that might arise in the future, some considerable time after the security right is created. This will occur where the parties have negotiated a financing that involves the provision of further/additional finance from time to time. Unless a secured transaction law is able to accommodate such future money advances, each increase of funds or additional lending will require a new security to be created at the time each additional advance is loaned. That would be inefficient in terms of time and cost and would have a negative impact on the availability and cost of credit. So the secured transaction law must provide for or permit a security right to be created to secure money obligations that will arise in the future.

Fluctuating amount of debt

This occurs when the parties negotiate a loan that might impose a maximum amount or limit of funding but which enables the borrower to draw against that funding from time to time and also to repay amounts from time to time. Under that type of facility, the money obligation need not be specific (in the sense that it need not always be a known, specified, exact sum of money, and may even be a ‘nil’ or credit balance at some point without the debt obligation itself terminating and with that, the security right). The secured transaction law must take account of such financing techniques (such as revolving loans) where the amount of debt will fluctuate from time to time. A secured transaction law must be capable of accommodating a ‘line of credit’ because it is a common form of finance facility. So the secured transaction law must provide for or permit a security right to be created to secure a fluctuating debt.

Maximum amount

In some jurisdictions it is necessary, whether or not the secured transaction law permits of fluctuating/future amounts of debt, to require that a maximum amount of debt be stated. This, it is claimed, helps to protect the borrower against over indebtedness. Other jurisdictions simply permit a general description, such as *'all monies now or in the future as may be owed between [secured creditor] and [debtor].'*

Summary:
As regards the requirement for a debt or money obligation, the secured transaction law will need to:

- Use and define relevant terminology (such as debt, or money obligation, or money liability).
- Make it clear that a grantor of a security right need not be a 'debtor' (to the creditor or grantor). The grantor could be a third party guarantor who would have a contingent debt or money obligation to the creditor. Such a contingent liability is a money obligation for the purposes of the secured transaction law.
- Provide for future debt.
- Provide for fluctuating debt.

4.1.3. Collateral

This area deals with the type and nature of property that may be the subject of a security right (collateral).

Fixtures

Certain objects, such as plant and equipment, office partitions, light fittings, air conditioning, commence their existence as movable property. They may, however, later become fixed to land or immovable property. Depending on the degree of 'fixation' (which might be tested by determining, for example, how easy is it to 'unfix' the particular object), the asset will either become part of the land and be regarded as a 'fixture' (and, hence, immovable property) or it will not and will continue to be classified or categorized as movable property. It is important that there is full clarity and certainty on the legal regime applicable to these objects in order for creditors taking security over them to be confident about their rights.

It is important to identify what the law is and how it operates in relation to this issue. Depending on that, it may be necessary that the secured transaction law makes it clear that it either applies or does not apply to this type of property. The more usual course for a secured transaction law to take is to *apply* the secured transaction law to a 'fixture'.

Tangible/intangible assets

The most obvious form of movable property is a tangible object (as, for example, a chair, motor vehicle, jewellery and so forth). Such objects have a physical existence, can be seen, touched, held, possessed and so forth. Clearly, a secured transaction law should apply, without restriction, to all tangible movable property assets.

In contrast, intangible property has no physical dimensions and cannot be seen, touched or possessed (except in a case where the property might be represented by some form of documentary title or certification of ownership right). The most relevant examples of intangible movable property assets for the purposes of a secured transaction law are receivables and intellectual property. It is desirable that all forms of movable property are capable of being granted by way of security under a secured transaction law.

Receivables

A receivable is another word for a debt for which a person (the debtor) is liable to another (the creditor). In simple form, a receivable is a debt that is owed by AD (the account debtor) to AC (the account creditor). The right to receive payment of the debt, the right to collect the debt, the right to sue for and recover the debt from AD is an asset of AC.

As with any other form of movable asset, AC may use the asset to provide security for the provision of credit.

Receivables are a valuable asset. They are generally more highly valued by a lender than, for example, inventory. They provide an acceptable and very useful form of security.

In a typical example, AC, who sells most of the goods it manufactures on credit sales, has from time to time a number of receivables due to it as a result of the credit sales. AC seeks to raise finance by using the receivables to provide security to a financier. AC agrees with the financier to secure (by assignment or transfer) AC's rights in relation to the receivables to the financier. Thus AC becomes the grantor of the receivables, the financier is the secured creditor of the receivables and the account debtors are the persons who are liable to pay the relevant receivables.

If AC defaults in its obligations to the financier, the financier would take formal 'control' of the receivables by giving notice to the account debtors of the assignment/transfer of the relevant receivables to the financier and requiring the account debtors to pay the receivables to the financier and not to AC.

Intellectual property/other intangible property

This unique form of intangible property is usually subject to a specific law that deals with the concept, creation, ownership, etc. In many instances there will be a means of 'registering' such property and obtaining ownership protections and rights (for example, a patent law). Intellectual property is perfectly capable of being used to provide a security. Issues arise, however, as to whether a secured transaction law is best suited to provide for such use or whether it is more appropriate for the relevant intellectual property law to so provide. It is recommended that the secured transaction law be comprehensive and covers all types of collateral, including intellectual property. If necessary, special provisions within the secured transaction law can be added to take account of the specific character of intellectual property as collateral.

Identification of assets

Only some types of movable assets are capable of a detailed and precise identification. Examples are motor vehicles (registration number, engine number), large plant and equipment, certain types of office equipment (computers). But such identification is not possible for the great bulk of movable assets (for example, inventory, receivables, raw materials).

A secured transaction law should recognise this and not impose burdensome and costly identification requirements upon the parties. It may do this by permitting the use of general descriptive terms (such as '*all of the inventory from time to time located at the business premises of* [the grantor] *situated at* [address]').

Future property – The case for inventory financing

The parties involved in a secured transaction may have legitimate questions as concerns identifying as potential collateral assets that either do not presently exist or, even if they do exist, are not presently owned by the grantor. This species of property is normally termed 'future property'.

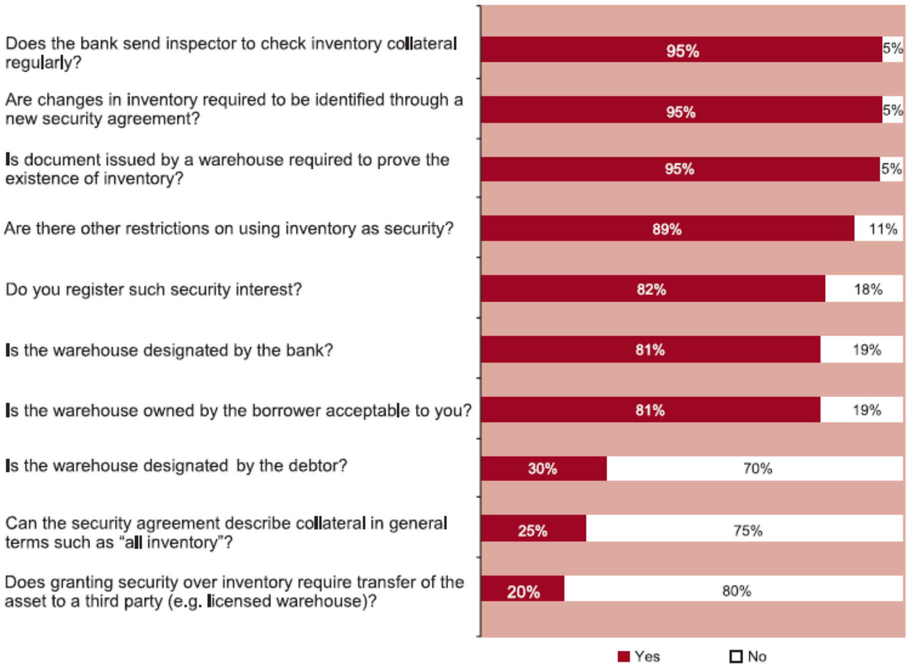
It is highly recommended for a modern secured transaction law to provide that future movable property may be the subject of a security right. The basic reason why a secured transaction law should accommodate future movable property is that certain types of movable property that are used or associated with business enterprises will be constantly changing and fluctuating. Examples are raw materials constantly used in a manufacturing industry, inventory that is constantly sold in a retail store, receivables that are constantly created in a business that sells its products on credit sales. What is in the factory or retail shop today may not be in the factory or shop tomorrow. And if it is not it will normally be replaced. Likewise in the business that sells its product on credit sales, old receivables will be paid or discharged and new receivables will be created.

Thus if a financier takes security over, for example, all the inventory in a retail store on day 1, by day 2 some of that will have been sold and other new inventory will have come into the retail store. Viewed from the point in time when the security was created, the new inventory is future property. Either it did not exist when the security was created or, if it did, the retail store did not then own the inventory. However, if the parties have agreed that the security right will cover new inventory, it does not matter whether it existed or was owned because the security right will be effective to cover it.

If the secured transaction law did not permit such a transaction it would be extremely difficult for both an enterprise and a financier to create an effective form of inventory security. In the example above, a new security right would have to be created on a daily basis if it was to be effective. But that would be extremely inefficient, if not impossible. It should only be necessary to create just the one security right to cover present and future property.

Since many of the assets of many enterprises are constantly changing and fluctuating it is highly desirable that the secured transaction law should enable future property to be granted by way of security.

Box 18: How are banks currently exercising inventory financing?



Source: IFC-VBA Financial Sector Survey.

Generally described assets / all assets security right

Consideration should be given to allow generally described assets to be the subject of security rights. The description of these assets should be very flexible, including all of the (movable) assets of the grantor.

A particular feature of this form of security right is that the enterprise will normally be able to deal with most of its assets (for example, selling inventory, stock–in–trade) without the need for the consent/agreement of the financier provided that the dealing is in the normal course of its business. At the same time, the financier is adequately protected because, since the security right is an 'all assets' security right, it would cover not only the assets that are subsequently sold but also the cash or receivables that are generated by such sales.

If such an 'all assets' security right is considered desirable, it will be necessary that the secured transaction law make some special provisions regarding the form it may take, priorities between it and other security rights (for example, a retention of title supplier, an inventory security right) and enforcement.

Proceeds, proceeds of proceeds, fruits and products

A characteristic feature of movable property is the fact that it is often made in order to be sold, leased or licensed. When encumbered assets are sold, exchanged or otherwise disposed of, or leased or licensed during the time in which the obligation they secure is outstanding, the grantor typically receives, in exchange for those assets, cash, tangible property (e.g. goods or negotiable instruments) or intangible property (e.g. receivables). This being the case, States must determine whether a security right that is taken in the initial property should extend to new property that is received in exchange for that property when it is sold or disposed of. For example, States are required to decide whether a security right in a piece of equipment like a printing press extends into the money that is received by the grantor when it sells the printing press, or into another printing press that is received in exchange for the press that has been sold.

In the terminology of property law, such cash or other tangible or intangible property received in exchange upon a sale or other transfer is considered to be "proceeds of disposition".

In some cases, the proceeds of the originally encumbered assets may generate other proceeds when the grantor disposes of the original proceeds in return for other property. Such proceeds are sometimes referred to as "proceeds of proceeds". If there is a right in proceeds of encumbered assets, it should extend to proceeds of proceeds. If the secured creditor loses its right in the proceeds once they take another form, the secured creditor would be subject to the same credit risks as would be the case if there were no rights in proceeds.

A further feature of movable property is that it is susceptible to numerous legal and physical transformations over time. For example, if tangible movable property is an animal, various modifications are possible. Female animals give birth to offspring, and produce milk. Other animals may be shorn for their wool. Still other prize animals may produce marketable products. Bees may produce honey, and silk worms may produce silk. In all these situations, encumbered assets may generate other property for the grantor even without a disposition of these assets. In many legal systems, this type of property is referred to as "natural fruits".

Transformation also occurs in relation to intangible property. For example: a right to receive payment may carry interest; a lease of tangible property results in rental payments. These are often known as "civil fruits" or "revenues". In addition, if the tangible property is an object, it may be manufactured or transformed. Wood may become a chair. Steel may become part of an automobile. Here, the initially encumbered asset is not disposed of, but the process of manufacture turns it into another, more valuable, object. Property that results from such transformation is often called "products".

For the purposes of secured transactions law, however, the specific label is often not that important. What matters is the policy decision that States take concerning the effect of the security right in the fruits, revenues and products. That is, in each of these cases, States must decide whether a security right that is taken on the animal, steel, right to payment or the object subject to lease, may extend to any of the property "produced" by that original property.

In some legal systems, civil or natural fruits are clearly distinguished from proceeds arising from disposition of encumbered assets and are made subject to different rules. The difficulty in identifying proceeds of disposition and the need to protect rights of third parties in proceeds is often cited to justify this approach. Other legal systems do not distinguish between civil or natural fruits and proceeds of disposition and subject both to the same rules. The difficulty in distinguishing between civil or natural fruits and proceeds, the fact that both civil or natural fruits and proceeds flow from, take the place of or may affect the value of the encumbered assets are among the reasons mentioned to justify this approach. Moreover, parties typically provide in their security agreement that the security taken on the initial property extends into all these other forms of property. For this reason, some States consider all these transformations to constitute "proceeds" of the originally encumbered asset. Because this is the normal contractual practice in secured transactions regimes today, in this study, all the above transformations are considered as "proceeds" arising from the initially encumbered assets.

(a) Scope of security right in proceeds

A legal system governing security rights must address two distinct questions with respect to proceeds:

- Whether the secured creditor retains the security right if the encumbered asset is transferred from the grantor to another person in the transaction that generates the proceeds. Strictly speaking, this is not a proceeds question. Rather it relates to the issue whether a security right comprises what might be called a "right to follow" (droit de suite).

- The second issue concerns the secured creditor's rights with respect to the proceeds. The justification for a security right in proceeds lies in the fact that, if the secured creditor does not obtain such a right, its rights in the encumbered assets could be defeated or reduced by a disposition of those assets and its expectation to receive any income generated by the assets would be frustrated.

If the legal system did not permit the creation of a security right in proceeds upon disposition of encumbered assets, it would not adequately protect the secured creditor against default and thus the value of encumbered assets as a source of credit would diminish. This result, which would have a negative impact on the availability and the cost of credit, would be the same even if the security right in the original encumbered assets were to survive their disposition to a third party. The reason for this result lies in the possibility that a transfer of the encumbered assets may increase the difficulty in locating the assets and obtaining possession thereof, increase the cost of enforcement and reduce the value of the assets.

A right in proceeds typically arises where the encumbered assets are disposed of because the proceeds replace the original encumbered assets as assets of the grantor. In systems that treat civil or natural fruits as proceeds, a right in such proceeds may arise even if no transaction takes place with respect to the encumbered assets (e.g. dividends arising from stocks) because this is consistent with the expectations of the parties.

If the secured creditor's right in proceeds is a proprietary right, the secured creditor will not suffer a loss by reason of a transaction or other event, since a proprietary right produces effects against third parties. On the other hand, granting the secured creditor a proprietary right in proceeds might result in frustrating legitimate expectations of parties that obtained security rights in those proceeds as original encumbered assets. However, in legal systems in which creation is distinguished from third-party effectiveness and priority, this result would occur only if the creditor with a proprietary right in proceeds had priority over the creditors with a right in proceeds as originally encumbered assets and such priority is determined on the basis of time of registering of a notice about the transaction in a public register. Thus, in those systems, potential financiers are forewarned about the potential existence of a security right in assets of their potential borrower (including proceeds of such assets) and can take the necessary steps to identify and trace proceeds, and to obtain inter-creditor subordination agreements where appropriate.

Slightly different considerations apply where the proceeds in question are not proceeds of disposition, but are fruits, revenues, and the increase of animals or the products of manufacture. In the last case, it would be the normal expectation of the parties that raw materials would be manufactured. The policy question is, consequently, whether a State should adopt a rule that requires a security agreement to explicitly provide that the security is taken not only in the raw materials but also in any product that is manufactured from these raw materials or whether the assumption should be that the manufactured products are automatically covered by the security right and, if the parties do not wish this to be the case, they should so state in the security agreement. Most States do not require parties to specify that the security right passes into property manufactured from raw materials, as long as it can be clearly identified as having resulted from those raw materials.

Similar considerations bear on the decision whether parties should specify that the security right extends to offspring of animals, or whether they are automatically covered. As the normal expectation of the parties is that new-borns would be covered, most States provide that a security right in the mother, also automatically covers offspring. As for natural fruits (for example, wool, milk, eggs not hatched, and honey), States take different positions. Many States require parties to specify in the security agreement that these natural fruits will be covered by the agreement. Other States provide that natural fruits are automatically covered unless the parties provide otherwise. In keeping with the general orientation of this Study to provide recommendations that would be consistent with the normal practice of parties to a security agreement, the approach adopted is to consider these natural fruits to be automatically covered by the security agreement in the animal that produces the fruits.

Finally, as concerns civil fruits or revenues, reasons of economic efficiency normally would suggest that a security right in the capital payment (e.g. a negotiable instrument, or receivable) should also embrace a right to the interest payable. This is because payments on such instruments or receivables are often blended payments of capital and interest. Only where it is easy to separate the repayment of the capital from the interest charges, and where the parties agree that the security right in the capital sum not extent to the separate interest generated, should the law permit the interest to be several from the initial obligation.

(b) Creating a security right in proceeds

The discussion above shows that there are practical reasons why many legal systems extend security rights in encumbered assets to various forms of proceeds (including proceeds of proceeds) through default rules applicable in the absence of an agreement to the contrary. In other legal systems, where an automatic right in proceeds does not exist, whether in respect of proceeds of disposition or in relation to one or more categories of fruits, increase of animals, revenues, or products, parties are typically permitted to specify that they will take security rights in all types of asset as originally encumbered assets.

In such systems, parties may be free to provide, for example, that a security right is created in substantially all of the grantor's assets (cash, inventory, receivables, negotiable instruments, securities and intellectual property). In such a way, the proceeds themselves become originally encumbered assets and are covered by the security right of the creditor even without a legal rule automatically providing a right in proceeds. In some of those legal systems, parties may also extend by agreement certain title-based security rights (e.g. retention of title) to proceeds.

Regardless of whether a right in proceeds flows automatically from a right in the originally encumbered assets, or whether it must be explicitly mentioned in the security agreement, there are no additional formalities imposed on parties that seek to claim a right in any of these forms of proceeds. The only requirement is that, in the former case, the security agreement should specify a right in the proceeds, and indicate the kinds of proceeds that are meant to be included in the same security right, while in the latter case, it is sufficient to clearly identify the assets that are subject to the initial security right.

In line with its general objective of facilitating secured credit, this study recommends approaches that will reflect the normal expectations of grantors and secured creditors that a security right in encumbered assets automatically extends to its identifiable proceeds <u>without</u> the need for parties to so provide in their security agreement.

Commingled proceeds

When the assets that constitute proceeds of encumbered assets are not kept separately from other assets of the grantor, the question arises as to whether the security right in the proceeds is preserved. The answer to this question usually depends on whether the assets constituting proceeds are identifiable. Proceeds in the form of tangible property kept with other assets of the grantor can be identified as proceeds in any manner that is sufficient to establish that the items of tangible property are proceeds. In this respect, many States provide that the same principle that governs the preservation of the secured creditor's right in originally encumbered assets that has been commingled should also apply to tangible property that constitutes commingled proceeds. So, for example, if a grantor receives a certain amount of gasoline as a swap for crude oil that has been sold, and the gasoline in commingled in a tank, the security right should continue into a proportion of the gasoline in the tank, as long as the secured creditor can prove that that amount of gasoline was received as proceeds, and no additional steps are required in order to create (or preserve) the security right in these commingled tangible proceeds.

If, by contrast, the property constituting proceeds is intangible, such as receivables or rights to payment of funds credited to a bank account, and is not maintained separately from the grantor's other assets of the same type, such intangible property may be identified as proceeds as long as it can be traced to the originally encumbered assets. For example, as long as the secured creditor can prove that a certain amount of cash has been deposited as proceeds of the disposition of encumbered assets, then a proceeds claim could arise. The difficulty is that money is constantly entering and exiting from bank accounts, and it is difficult to know what percentage of the money has actually originated as proceeds.

The law should provide that the identifiable proceeds will consist of all funds deposited as proceeds, as long as the balance of the account is greater than the amount deposited as proceeds. Where the total amount is less than the total amount of proceeds deposited to the account, the identifiable proceeds are determined by taking the lowest intermediate balance and adding to it any further money in the form of proceeds added to the fund since that lowest balance was recorded. As with the case of commingled tangible proceeds, as long as the source of the intangible proceeds can be traced, no further steps need be taken by the parties in order to create (or preserve) the security right in these commingled intangible proceeds.

Commingled tangible property

Historically, secured transactions regimes did not face the problem of maintaining identification of encumbered assets. Because security rights could be taken only on individually identified assets, it was rare that commingling of fungible property could arise. Today, however, many States permit parties to create a security right in a general category of (usually fungible) property. For example, the security could be taken in assets described as "*all my present inventory of personal computers*"; alternatively, a seller could take security in all the personal computers that it sells to a purchaser. In both these cases, it may be that assets subject to the security right are commingled in a manner that prevents separate identification with other assets of the same type that are not subject to the security right.

Two approaches are possible:

- Under the first approach, once the property is commingled, it is no longer identifiable and the creditor's security right is lost. This approach places the burden on the secured creditor to ensure that the grantor keeps the encumbered assets separated from other assets of a similar nature to prevent commingling.

- Under the second approach, the security right survives and may be claimed in the commingled assets in the same proportion as the encumbered asset bore to the total amount of the commingled assets. Under this approach, if $100,000 worth of oil is commingled with $50,000 worth of oil in the same tank, the secured creditor is deemed to have security over two-thirds of whatever oil remains in the tank at the moment it becomes necessary to enforce the security.

As this study adopts the general principle that security rights should be protected as much as possible, it recommends that the second approach (i.e. preservation of the security right in the commingled property in the same proportion as in the encumbered assets and the assets not encumbered by the security contributed to the mass) be adopted. In other words, once a security right is created in the encumbered assets, no further steps are necessary to preserve that security right should the encumbered asset ultimately be commingled with similar assets of the same type that are not subject to the security right.

Tangible property commingled in a mass or product

When tangible property is so mixed with other tangible property that its separate identity is lost in a product or mass, it is necessary to determine the conditions under which a security right in the original asset may be claimed in the product that has been produced. For example, it may be that a security right is taken in flour that is destined to become bread through manufacturing or production.

Two basic approaches are taken in various legal systems:

- Under the first approach, once the flour loses its identity as flour, the security right is extinguished. If the parties wish the security right to pass into the bread, it is necessary to provide that the original security encumbers both flour and any product into which the flour may be transformed or manufactured.

- Under the second approach, the security right automatically passes into the manufactured product as long as it can be established that the product resulted from the raw materials subject to the security right.

As it is the normal expectation of the parties that the raw materials will be manufactured, this study takes the position that it should not be necessary to provide in the security agreement that the security right passes into the manufactured product. The resulting product is in some sense the replacement or substitute for the security right in the no longer existing raw materials.

4.1.4. Types of transaction – Integrated and functional approach to security

It is necessary to consider what types of transaction are covered under or which are subject to the secured transaction law.

Throughout the twentieth century, the credit demands of business were often frustrated by the lack of a suitable legal framework through which borrowers could grant security rights to lenders and other credit providers. Sometimes, the law explicitly prohibited the granting of security over certain types of asset.

Sometimes, an appropriate legal device simply did not exist. Sometimes, parties were able to cobble together a legal device to serve their purposes, but it was inefficient, costly and complex to operate. These problems led to contractual practices and legislative innovations permitting fictitious “pledges” and the creation of specialized legal transactions meant to solve problems created in particular sectors of economic activity. They also stimulated the development of a variety of transfer- of-title mechanisms. They lay behind both the extensive deployment of retention-of-title agreements, and the different variations on retention of title intended to increase its efficiency as a legal device for securing the performance on an obligation.

Faced with the complexity, inefficiency and gaps created by this *ad hoc* approaches to adjusting legal regimes to meet the credit needs of business, by mid-century some States decided to rethink the whole field of security rights in movable property. The creation of a single, integrated, comprehensive and functionally defined security right in all types of movable property was the result of this reflection. This approach to security rights was inspired by the observation that the many different types of non-possessory security rights, the traditional possessory pledge and the several variations on title-transfer and retention-of-title devices are all based upon a few identical guiding principles that aim at achieving the same functional outcomes.

The main theme in this new approach to security rights is that substance must prevail over form. It is no accident that this idea first developed in federal states, such as the United States of America and Canada. The United States Uniform Commercial Code (“UCC”), a model law now adopted by all fifty states (including the mixed common law and civil law State of Louisiana), created a single, comprehensive security right in movable property unifying numerous and diverse possessory and non-possessory rights in tangible property and intangible property, including transfer- and retention-of-title arrangements, that existed under state statutes and common law.

The idea spread to Canada (including the civil law jurisdiction of Quebec), New Zealand India, and various other States. The Inter-American Model Law on Secured Transactions follows a similar approach in many respects. The EBRD Model Law follows a similar approach to the extent it creates a specific “security right” which can work side by side with other security devices (e.g. leasing) and recharacterizes retention of title as a security right.

As an approach to creating an efficient regime that enhances the provision of low-cost credit to businesses and consumers, an integrated comprehensive security system presents certain important advantages:

- All relevant statutes dealing with non-possessory security rights (which are often great in number) may be merged into one text, an approach that ensures comprehensiveness, consistency and transparency of the rules.

- The rules on possessory security rights, especially the possessory pledge, may be covered and at the same time adapted to contemporary requirements (e.g. by introducing the notion of control in relation to security rights in intangible property).

- Title devices, such as the security transfer and the retention of title, may be integrated into the system in a way that not only gives sellers the protection they desire, but also enables buyers to use whatever value they have acquired in property purchased to obtain additional credit.

- Contractual arrangements that fulfil a security function, such as leasing contracts, sale and resale, may also be included and covered in a way that minimizes conflict and confusion about the priority of the rights of different creditors.

- In addition, under this approach, a creditor that envisages granting a secured loan, need not investigate various alternative security devices and evaluate their respective prerequisites and limits as well as advantages and disadvantages. Correspondingly, the burden borne by the grantor’s creditors, or the insolvency representative for the grantor that must consider their rights (and duties) vis-à-vis the secured creditor is lessened if only one regime, characterized by a comprehensive security right, has to be examined rather than several different regimes. Further, this will reduce the cost of creating security rights and, concomitantly, the cost of secured credit.

- In cross-border situations, the recognition of security rights created in assets in one State that are then moved to another State will also be facilitated, if the State into which the assets are moved recognizes a comprehensive security right. Such a system can much more easily accept a broad variety of foreign security rights, whether of a narrow or an equally comprehensive character.

There are, however, some disadvantages to the integrated, comprehensive approach:

- This approach may require re-characterization of certain transactions (e.g. transfer of title for security purposes or retention of title), at least for the purpose of secured transactions laws.

- This approach requires adjusting the basic legal logic that has heretofore underpinned the law relating to security rights in many States. In these States security rights are conceived to be exceptions to the general principle of equality of creditors and must therefore be restrictively interpreted.

- Moreover, security is usually conceived as a specific right, over specific assets, to secure a specific obligation, owed by a specific debtor to a specific creditor. The integrated and comprehensive approach presumes that these traditional limitations will be displaced by a general principle favouring the spread of secured credit.

- Finally, this approach normally assumes that the new regime will be brought into force in a single piece of legislation. For some States this will involve significant adjustment to the manner in which their civil codes, commercial codes or other statutes are organized.

Many of these disadvantages can be reduced or eliminated by careful attention to the manner in which a State chooses to elaborate legislation creating an integrated and comprehensive security right. For example, it would be possible to achieve most of the advantages while avoiding most of the disadvantages through:

  - A comprehensive reform of existing laws relating to security rights, title devices serving security purposes, the assignment of receivables and financial leases, and

  - The enactment of specific statutory rules to regulate contractual practices that have been developed to overcome gaps in the law. In any case, the effort required to do so in a manner that would achieve consistency, transparency, efficiency and the establishment of genuine competition among all providers of credit on the basis of price would be considerable.

If a State were to adopt an approach that favoured the enactment of a comprehensive, integrated regime, technically, either of two different approaches could be used:

  - Under one approach, the names of the old security devices, such as pledge, floating charge, transfer of title for security purposes and retention of title, would be preserved and used. However, their creation and effects as security rights would be made subject to an integrated set of rules, even though they would continue to have their full title effects for other purposes (e.g., taxation or accounting).

  - Under a slightly different approach, all types of rights serving security purposes would be subsumed into a unitary notion of security right and the rules applicable to certain basic types of contract that may be used for purposes of security, such as sales, leases or assignments, would be supplemented by certain specified additional rules (e.g. with respect to third-party effectiveness, priority and enforcement).

This study recommends the establishment of an integrated, comprehensive secured transactions regime as the approach that will most effectively promote secured credit. It also recommends that States adopt the second of the two techniques just elaborated for doing so (an approach that may be described as a functional and unitary approach). However, the study also recognizes that some States may not be in a position to adopt the functional and unitary approach to acquisition financing rights and therefore contemplates that, in this particular situation, States might choose to adopt the first approach to achieving a comprehensive and integrated regime, an approach that might be characterized as a functional and non-unitary approach.

4.2. Creation of a security right

This part of the study is directed at the manner in which a security right might be created and what the secured transaction law should provide to facilitate such creation. The relevant Principle for an efficient secured transaction law outlined in Part 2 above states:

> 'The law should enable the quick, cheap and simple creation of a proprietary security right without depriving the person giving the security of the use of his asset'.

4.2.1. Contract

Creation of security principally involves a consensual contract. Non-consensual creation might also be possible as, for example, from the application of a law relating to the effect of a judgment for the payment of money and which provides that a judgment debt attaches to (operates as a security over) the assets of the judgment debtor. This study concentrates on consensual creation.

4.2.2. Credit/loan contract and security contract

As mentioned before in the study (§4.1.2 (1))**,** a movable asset security may only exist if there is a debt or monetary liability underlying the security. Accordingly, there might be two contracts involved:

- One that constitutes the loan or finance or other form of credit agreement between the creditor and the debtor as a result of which a debt or money obligation will arise, and
- The other that creates a security right over movable assets of the debtor/borrower as security for the debt/monetary obligation.

Alternatively, the two contracts might be rolled into one. This study is only concerned with the security contract, whether that incorporates the loan contract or not. It is not usual for a secured transaction law to deal with the creation of a loan, finance or credit contract between the parties.

4.2.3. Validity between the parties

The third point to make is that this part of the regime deals only with validity as between the parties to a security contract – usually the grantor and the secured creditor. It does not purport to govern validity or effect as regards third parties (for effectiveness vis-à-vis third parties, see §4.3 below). Thus, a security contract might be valid between grantor and secured creditor, but not as against a third party (because, for example, as a result of a failure to register as mentioned later). A security contract that is invalid between the grantor and secured creditor will also be invalid and of no effect as regards third parties.

4.2.4. Relevance of contract law

Since a security contract will be a species of contract, the relevant law relating to the formation of and the formalities required for the creation of a valid contract will govern the basic fundamentals of a security contract. A secured transaction law might supplement that law where necessary, as, for example, to establish a requirement that a security contract must be in writing and must be signed by both parties. That requirement might, however, be dispensed with in the case of a possessory security right.

4.2.5. Simplicity of creation

Since one of the aims of a modern secured transaction law is to encourage the use of collateral and lessen time and cost, it is necessary to endeavour to make the act of creation relatively simple and non-formal. Any formal requirement, which necessarily requires time and costs, would need to be justified. That, however, has to be tempered with legitimate concerns to ensure contractual consensus and to maintain relative bargaining strength between the parties.

4.2.6. Writing

It is acceptable to require that a security contract be in writing. The reasons include that a security right involves the creation of a proprietary right over the assets of a person and policy reasons may dictate that such a contract should be in writing to protect the grantor. It is also important that there should be clear evidence of the creation of a security right since third parties may be affected by it. Writing provides the most reliable evidence.

4.2.7. Signing

Likewise it is usual to require that a security contract be signed, at least by the grantor, and, even more appropriately, by both parties. There is little point in insisting upon writing and not insisting on signing by both parties. It provides further protection and evidence for the reasons mentioned above.

4.2.8. Dating

It will usually be necessary to require that a security contract be dated. This might be important for two reasons:

- The first is that an insolvency law will often provide for certain transactions (including secured transactions) to be voidable in certain circumstances (sometimes referred to as 'clawback' provisions). The date of the transaction can be very important within this context because most 'claw back' provisions operate within a certain time scale proximate to the commencement of the insolvency case.

- The second is that registration particulars may not provide as reliable information as may be found in the security right agreement itself. Hence the need for both dating and signing. Another reason for dating is that priority between two secured parties who hold separate unregistered security rights over the same assets may, in some circumstances, be determined by the application of a rule that accords priority to the first in time of creation.

4.2.9. Basic contract inclusions

The law should specify that the contract contain the names and addresses of the parties, the assets that are to be secured, and the debt/monetary obligation the security right secures. The law might also provide that the terms as to the obligations of the parties in respect to the collateral (for example, that the grantor will insure, keep the asset in good condition, whether the grantor is entitled to sell some of the assets, whether a subsequent security right over the same assets is allowed, and so forth) be set out in the contract.

4.2.10. Maximum amount of debt

If it is determined that the law shall require that a maximum amount of debt must be stated**,** the contract will have to so provide this information.

Box 19: Features of reformed and unreformed systems for secured transactions in a nutshell – Creation

Feature	Reformed systems	Unreformed systems	Economic loss compared to reformed systems
Scope	• Allow security rights to be created by any lender and borrower, in any present or future property, and in all transactions.	• Do not cover all types of movable property, lenders, borrowers, and transactions. • May exclude after-acquired or after-produced goods.	• Borrowers unable to use full value of property as collateral under the law, because the law will not uphold the security right. • Unused assets result in dead capital.
Generality or specificity of identification of collateral	• Allow the creditor and debtor to describe the collateral in general terms (“all my inventory”) or specific (“machine No. #123”). • Allow the composition of collateral to permutate and to get replaced. • Permit security rights to float on a broadly defined set of goods serving as inventory, or on accounts receivables.	• Require security agreements to specifically identify collateral, such as each item of equipment. • Do not consider inventories as assets eligible for collateral once they leave the warehouse or change in composition.	• Several types of goods that could serve as collateral are difficult to identify specifically, e.g. inventory. • Loans can be impossible to monitor because of the need to track each specific item of collateral. • Accounts receivable and chattel paper cannot serve as collateral.
Whether rules on description of collateral allow use of after-created or after-acquired property	• Permit all property, whether it presently exists or not, to serve as collateral for a loan.	• Permit pledging only of collateral that presently exists. • May take small steps toward after-acquired collateral by permitting specific pledges such as of a future crop. Cannot cover all possible transformations of goods.	• Lenders cannot finance a farmer before the crop is planted or a manufacturer before the output is created. • Producers cannot obtain financing for inputs secured by future outputs, even though the transformation from inputs to outputs is precisely the point at which producers most need working capital.

Source: *The World Bank – Reforming collateral laws (2006).*

4.3. Publicity (effectiveness against third parties)

Creation of a security right primarily operates between the parties to the security agreement. However, the security right will not become effective against third parties unless it is registered or another step is taken such as taking possession or control. This further step is variously termed protection, publicity, effectiveness or a term derived from French *opposabilité*.

Whatever term is used, it conveys the objective of protection against/of third parties. The principal person who will benefit of the protection is the secured creditor as well as third parties that have had or will have dealings with the grantor in respect of the collateral. The range of persons against whom the secured creditor will be protected include other creditors who may obtain a security over the same asset, subsequent purchasers of the asset, unsecured creditors of the grantor, and the insolvency representative of the grantor.

To gain this protection it is necessary for the secured transaction law to provide the means by which it may be obtained. This area, therefore, deals with *how* a secured creditor can obtain protection. It does not deal with *when* that protection takes effect, nor does it deal with the *effect* of protection. Those areas are taken up in the part dealing with registration.

The relevant principle outlined in Part 2 for an efficient secured transaction law is:

> The law should establish clear and predictable priority rules.

There are two approaches to obtaining protection:

- In the **possessory form of security right** (pledge for example), protection is obtained by the grantor being dispossessed of the collateral. This is usually accomplished by delivery of the asset to the secured creditor or the agent of the secured creditor.
  The act of dispossession takes the asset out of the possession of the grantor (so that unauthorized sales or other dealings with the asset become impracticable) and provides notice of the probability that the asset has been granted by way of security or, at least, puts third parties on notice that it may be the case, particularly in the case of a security right over assets for which it would be normal to assume that the security right is publicized by delivery of the assets (as, for example, in relation to nominative share certificates). Dispossession also eliminates the appearance of false wealth. Once the act of dispossession occurs, the security right becomes effective against third parties. It is not usual to require any form of registration.

- In the **non-possessory form of security right**, possession of the asset is retained by the grantor. Protection is best provided by a public registration system. Such a system enables a secured creditor to register the fact of the creation of a security right in the registry. Because it is a 'public' registry and is open to search by the public generally, the term 'publicity' becomes more easily understood. Once registered, the secured transaction law would provide that the security right becomes effective against third parties.

4.3.1. Basic general rule of publicity

It is necessary for the secured transaction law to provide for means to publicize the security right. It may do so in a broad and general way by providing, for example, that:

'A security right becomes effective against third parties if:

- [The security right] [a notice of the security right] is registered in the [security right registry], or

- Possession of the collateral is delivered to the [secured creditor] or the agent of the [secured creditor].

4.3.2. Particular rules of publicity

It may be necessary to develop special rules as to how publicity might be affected in relation to particular types of secured transactions (for example, a security right over negotiable documents, bank account, etc.).

Assume that a financier has financed the purchase by an enterprise of goods from overseas. The enterprise agrees with the financier to grant the goods and documentary title to the goods as security. Title to the goods during their transportation is represented by a bill of lading. Possession of the bill of lading is given to the financier. It should only be necessary for the financier to rely on possession of the bill of lading to publicize its security over the goods themselves. It should not be necessary that the financier also registers a security right over the goods. The secured transaction law needs to provide for such a situation in a clear and unambiguous rule whatever policy choice is made.

4.3.3. Competing methods of publicity

It is also necessary to consider the issues of effectiveness in a case where there might be competition between a security right that has become effective by registration and a security right over the same property that is made effective by possession. Normally, the first in time should prevail.

4.3.4. Failing to publicize

The issue of a failure to publicize must be considered. In essence, the law could provide for two consequences:

- Total invalidity for failure to publicize. Failure to publicize invalidates the security right against everyone, including the parties to the security right.

- No effect on third parties. Failure to publicize could alternatively mean that the security right has no effect against third parties. A possible modification of this rule would provide that a non-publicized security right does have effect against a third party who has actual notice or knowledge of the creation/existence of the security right. This, however, raises issues of proving knowledge and associated uncertainties. It is usually preferable to provide for the simple rule that non publicity means no effect against third parties.

4.4. Registration

4.4.1. Purpose

The purpose of provisions on the registry system is to establish a general security rights registry and to regulate its operation. The purpose of the registry system is to provide:

- A method by which an existing or future security right in a grantor's existing or future assets may be made effective against third parties.

- An efficient point of reference for priority rules based on the time of registration of a notice with respect to a security right.

- An objective source of information for third parties dealing with a grantor's assets (such as prospective secured creditors and buyers, judgement creditors and the grantor's insolvency representative) as to whether the assets may be encumbered by a security right.

To achieve this purpose, the registry system should be designed to ensure that the registration and searching processes are simple, time- and cost-efficient, user-friendly and publicly accessible.

4.4.2. Registration procedures

Who can request registration?

The person entitled to request registration may be the grantor and/or the secured creditor (or an appointed representative). Whatever party requests registration, the other party will want to ensure that the form and content of the registration corresponds to what has been agreed. The secured creditor may do this by preparing the application form and/or by requesting registration on behalf of the grantor and/or by obtaining a printout of the entry in the register, as explained in more detail later. If the entry does not correspond to what has been agreed the remedy of the other party will normally derive from the security right agreement (for example, a right to refuse to make available the credit). Where the secured creditor requests registration, there may be a requirement that evidence of the grantor's consent has to be produced to the registrar. Alternatively the grantor may be given effective remedies against abusive registration (swift procedure before the courts, right to damages, etc.). Either way, any person should be given adequate protection against wrongful registration of a security right against his name. Any representative (for example, the employee of a company) or agent (such as a lawyer) of the grantor or secured creditor who requests registration should produce evidence of his authority to the registrar.

What should be registered?

As a minimum, it is necessary to provide information related to the identity of the grantor and a description of the collateral. Without that, the registration will not achieve its objective. The registry computer should also record automatically the time of registration (so that the chronological order of registration is indisputable) and the identity of the person who generates the entry (the registrar or its agent) into the registry database to be able to trace the origin of the entry. It is desirable that the register also shows:

- **The identity of the secured creditor**. This determines the security right with greater certainty and gives a prima facie indication of the person who is entitled to enforce the security right. It also enables any interested third party to make direct enquiry of the secured creditor about the security right and/or secured claim.

- **The description of the secured debt**. This enables any third party (such as the potential purchaser of the collateral or a prospective further creditor considering a security right over the same asset) to assess the extent of the existing security right and the amount and nature of the liability secured.

- **Commencement of enforcement**. Most security rights are never enforced. When enforcement does occur, it indicates a failure by the grantor (or debtor if different) to comply with his obligations and this is relevant information to a third party enquiring about the security right. Making public the fact that enforcement has commenced through the register ensures greater transparency and can also be an effective means of obtaining payment from a recalcitrant debtor. Appropriate sanctions should be provided in the law against a secured creditor who registers commencement of enforcement without justification.

- **Changes in priority**. When secured creditors agree to change their respective priorities they may wish to publicize this information in the register although it is not essential.

- **Period for which the security right has been created, if the security right is created for a defined period of time**. It is sometimes suggested that all registrations should be for a limited period, for example five years, after which they should automatically terminate unless extended. Such a rule may have been justified for paper-based registries which risked becoming clogged with obsolete entries, but is not appropriate for modern electronic registries. It is also undesirable because of the inconvenience of renewal and the risk of unintended failure to renew.

The information to be included in the register should be defined limitatively and should be compatible with the objective of ensuring effective publicity of security rights. The register should not become a repository for extraneous information which will tend to clog the register and render it less efficient. It is sometimes suggested that a negative security right agreement (an agreement under which a person restricts his right to create security rights) should be publicized via the register in order to make the negative security right binding on third parties. This would enable a bank or other creditor to ensure that its debtor would not give security to any other party. This is not necessary for the effective publicity of a security right and it is a separate policy issue whether the register should be used to publicize, and even make binding on third parties, contractual obligations of the debtor. It is also sometimes suggested that the insolvency of the person giving the security right should be shown on the register – it is likely to be relevant for any person enquiring about security rights to know if the grantor is insolvent. The practical difficulty is ensuring that this information is promptly and consistently recorded. It could be made a specific obligation of the liquidator or administrator. When electronic links between the security right register and the commercial or company register are established it should be possible to record this information automatically.

Presentation of information

Most modern systems provide for the filing of information by a notice. The security right register should incorporate this information and make it available so as to provide accurate and concise information in a manner that is standard, simple, and understandable to any person searching the register without reference to other documents.

- **Identification of persons** – The method of identification should provide a unique identifier for the person, thereby leaving no room for doubt as to who the person is and ensuring that all security rights given by the same grantor are indexed together. It should also ensure that a third party subsequently searching the register is able to find that person. Where the person already appears in another register (such as a commercial or company register) a compatible means of identification should be used for ease of reference and to enable subsequent electronic links between registers.

- **Description of collateral** – It may often not be practical or even desirable to give a specific identification of each collateral (for example, where a pool of assets or future assets are collateral). However, allowing vague general descriptions can lead to uncertainty (for example, 'machines', 'assets as described in the charging agreement'). The description should be designed to give a third party a clear and meaningful notice of what assets have been collateral (for example, *'machinery used for the production of widgets at X location'*, *'all assets of the debtor, present and future'*).

- There should be no requirement to indicate the value of the collateral.

- Where collateral have a serial number or other unique identification which is used in another public database (for example, motor vehicles, some high value computer equipment, plant and machinery) it may be desirable that this is included in the description, in order to eliminate doubt, to permit searches against the asset ID and to permit subsequent electronic links between registers.

There is danger of including too much information. Registering thirty pages of annexes from a legal agreement may satisfy lawyers but will make the register undesirably opaque for the public. A concise summary of detailed provisions of the security right agreement will often achieve the objectives of publicity more effectively. It should not be necessary to refer to other sources of information (such as the security right agreement or the parties) in order to understand the information in the register. It is always open to a third party to request information from the parties, but the system should not rely on the parties' willingness to provide the public with the information they need to obtain a meaningful description of the collateral.

The description of the secured debt can be short. It should state the principal amount of the claim (excluding interest and costs). Where the principal amount may vary (for example, a revolving financing facility or supplier credit) it should indicate the maximum principal amount. It should identify the debtor, where this is not the grantor. The description may also include the nature of the debt and the due date for payment. The rate of interest and information about other ancillary amounts secured may be included but any requirement to quantify them or give a detailed description should be avoided.

Registration process

To obtain registration a person will normally have to go to a registration office (unless direct electronic registration is possible). Some countries allow applications by post, fax or email, but it may be preferable, in developing countries, that the applicant is present to check the final entry and prove identity. It is desirable that registration offices are easily accessible in all main population centres. The register should be available to the public during defined office hours. Uncertainty or limitations as to the availability of the service will quickly discourage potential users.

At the registration office:

- The necessary information is presented to the registrar and the registrar checks that the minimum required information as required by the law (for example, as provided for in a statutory form) is included. The check should not comprise any verification of the information provided; it is not the role of the registrar to ensure the accuracy of information submitted for registration.

- The registrar checks and records the identity of the applicant. There should be a permanent record of who applied for registration. The name of the applicant may appear in the register and the evidence of identity is normally scanned or photocopied and kept by the registrar. The need to check identity is a reason to avoid applications by post, fax or email.

- The registrar converts the information provided by the applicant into the necessary format. The applicant should be required to submit the information in the appropriate form so that the conversion is limited to keying the information into the computer system. This work may be reduced by allowing the information to be presented in electronic form. It is desirable to avoid, as much as possible, 'human error' in the transcription of the information. This may be best achieved by technology that makes it a function of a computer transfer of information from the form that is filed or lodged onto the registry data base.

- The applicant should check and approve the information in the final form to be registered. The simplest procedure is for the registrar to print out the information in the exact form that is to be recorded in the register, and for the applicant to sign the print out. This becomes difficult if the application is made by post, fax or email.

- Where there is an electronic link between the security right register and other registers, checks should be made to conform the information between various registers. For example, where there is a link to the commercial register (for example, company, business register), entering the grantor's commercial registry ID number will automatically cause his other details (such as his address) to be entered in the security right register. (Where electronic links do not exist, a requirement to make such checks manually is likely to be cumbersome and the responsibility for precise and consistent information is best left with the applicant.)

- Where the grantor is not identified by a unique identifier (such as an ID or commercial registration number) the registrar should check whether the grantor has not already been entered into the register, for example under a slightly different identification such as different spelling.

- The information should be entered into the register, normally by electronic transmission from the registrar's computer to the central database.

- The registration system should record the identity of the registrar making the entry and refuse the entry if the registrar does not have the authority.

- The registration system should record either the time that the information was submitted for registration or of the actual entry of the information on the register. Anyone searching the register from that precise moment onwards should be able to see the new entry. The registrar should receive electronic information of the registration (usually in a matter of minutes) and should give a printout of the information to the applicant. The information should show the entry exactly as it appears in the register, and any earlier security rights already registered, so that the secured creditor can be confident of his ranking order. Where written information of registration is required, the registrar may certify the printout.

- **Direct electronic registration** by specifically authorized users may be permitted, particularly in the case of banks and financial institutions who are frequently taking security. In that case the user will need an authorisation code and will be responsible for carrying out the tasks of the registrar. Safeguards will be needed to ensure that the user complies with appropriate registration procedures. Where direct registration by a secured creditor is allowed it is not possible to check the grantor's consent to the entry.

Registration of changes or cancellation

The procedure for registering any changes to an entry in the register, or its cancellation, should be similar to that for the initial registration. The entry should be modified to reflect the change but a record should also be retained of the information as originally registered. During the life of a security right it will often be relevant for persons searching to know what changes have been made. Even after the security right is terminated and cancelled the entry should not be deleted from the database. It may be valuable to enable subsequent searches to show the information that was on the register on a specific date, in particular in the event of subsequent disputes. With modern computer systems the additional volume of information that this implies for the register is unlikely to present a major problem. It can be archived.

When a security right terminates it is usually the grantor who will want the registration to be cancelled, but in most cases he will not be able to do so without the consent of the secured creditor. It may be necessary for the procedures to place a duty and sanction on the secured creditor to attend promptly to cancellation.

4.4.3. Search procedures

Who can search the register?

It should be possible for any person to search the register.

What information is available?

All information that has been entered in the register should be available to a person searching. The information is submitted for registration with the intention that it be made public. Transparency is essential for the effectiveness of the system.

In some jurisdictions certain personal information (for example, personal ID numbers) may be subject to confidentiality rules. Where such information is included on the register (for example, to guarantee that all entries are indexed against the same grantor), it may be necessary to screen the confidential elements from public view, but this should be done in a way which does not affect public access to any other information registered.

Confidentiality or privacy should not be used as a pretext to withhold information from the public.

Presentation/content of information

The information on a security right should be shown in the register in a similar manner to that in which it was submitted for registration. It should not be abbreviated or edited. For example, it is important that a person searching sees the description of the collateral exactly as it was registered. The register should be indexed under the names of grantors in a strict alphabetical order. When searching against the name of a grantor, the list of all security rights granted by him should be clearly shown and it should be possible to access easily the entries made in respect of each of them. Where there is no security right registered against a grantor, this should be clearly indicated in the search results (the so-called “negative publicity”), for example by such a message appearing on the screen as a search result. Where an amendment has been made to the information registered, this should be made apparent to the searcher and details of the amendment (nature, time, person requesting) should be easily available.

Search process

To make a search a person may go to a registration office but preferably will be able to access the register via the internet. Where internet searching is not available, convenient search points should be provided so that any person, wherever situated in the jurisdiction, can have easy access. When making a search:

- The person requests the search either by completing a search form on the internet or by submitting a request form at a registration office/search point. It is not necessary for the searcher to be identified since any person is entitled to make a search.
- The search request will define the information to be searched. Most often this will be the identity of the grantor (in order to see what security rights, if any, have been registered against a particular person), but it may also be, for example, the serial number of a registered asset (such as a motor vehicle, provided there is an index of such information).
- The search system should be designed to facilitate the task of the user who is seeking information, for example:
    - When the search is made against the name of the grantor, other names with similar spelling should be shown and, where a name has been changed since original registration, the new name should be indicated.
    - When there are several identifiers attached to a person (name, date of birth, ID number), it should be possible for the searcher to search against one or several items as he chooses.
    - The search process should be simple and not require any particular expertise.
    - It should be possible to print the information as shown on the screen. It should also be possible to have search printouts certified by the registrar.

Historic information

A person may want to find out what was, and what was not, registered at any particular time in the past. If the time of every entry made on the register is recorded, and modified or cancelled information is retained, it should be possible to do this. When a security right has been cancelled for some time the record may be archived and subject to search only on special request.

4.4.4. Effects of registration

Using the register to determine a secured creditor's priority

Once a system of publicity is in place, it provides a convenient and simple means to determine the ranking order of security rights by chronology (time of registration) and also of other rights that are included on the security right register. The time of registration (presentation of information for registration or actual entry in the register) will usually be used as the determining factor for deciding the chronological order of ranking. If the determining factor is earlier than the time of registration (for example, the signing of the security right agreement), a person acquiring a right in the asset may find that his right is subject to a security right of which he had no notice. However, it is not the function of the register to publicize the definitive priority ranking order of security rights. Priority is likely to depend primarily on the time of registration but it may be affected by other matters not shown in the register, for example:

- Where secured creditors agree on a change in their priority ranking. Such a change may not be publicized (although it would normally only affect the rights of those who are party to the agreement).

- Possessory security rights which may not be registered. Other priority rules may also affect the mere chronological order – see §4.5.2 in this paper. In conclusion, a person wanting to determine the priority of a security right may have to make investigations beyond a mere search of the register.

Advance registration

There are circumstances where registration may be made before the secured creditor has obtained a security right:

- **After-acquired assets** – The most common example is where a security right secures a future asset (an asset not yet owned by the grantor). In this case there has to be advance registration if the security right is to be of immediate effect upon acquisition of the asset by the grantor. The secured creditor will not have a security right until the grantor acquires the collateral, but priority vis-à-vis other creditors registering a right against the grantor in the same asset will be from the time of registration.

- **Advance registration and pre-registration** – Some systems permit the registration of a security right in advance of the signature of the security right agreement. The secured creditor will not have a security right until the security right agreement is signed but priority will be from the time of registration. They may permit, as well or instead, *pre-registration*, where a notice is registered of the *intention* to register a security right in the near future. If the security right is actually registered within a prescribed time, priority is determined from the time of pre–registration. Advance or pre-registration may be useful where registration procedures are slow, and they may also be seen as an indication of the grantor's good faith during negotiations. However, since the introduction of rapid electronic registration systems the need for protecting priority in this way has largely disappeared. The advantages of allowing a potential secured creditor to take priority during the negotiations are debatable.

Reliance on information in register

An entry in the register gives notice that a security right may exist but, in contrast to a title register, the information in the security right register is not 'authentic'. That does not mean, however, that it cannot be relied on in specific circumstances defined by law, for example:

- The absence of registration (negative publicity) indicates to third parties that no security right exists which could have effect against them.

- Notices to other secured creditors can be validly made using the address published on the register.

- An insolvency administrator can base the review of existing security rights on the register and can require information of the existence of security rights by reference to secured creditors shown in the register.

Although registration may be necessary for the creation of a security right, it does not have ‘constitutive effect’ in the sense that it does not of itself make the security right valid.

4.4.5. Operation of the registry

Selection and duties of the operator/ registrar

There may be a wide range of options open when selecting the person who is to act as registrar and operate the registry, both in the public and private sectors. The single determinant factor is that the person or organization appointed should have the ability and capacity to operate the system in a manner which meets the legal and regulatory requirements and which gives optimum support to the secured credit market.

Supervision of the registry

Whoever operates the registry it is essential that there is an adequate level of government supervision and control. The nature of supervision may be different according to whether the registry is part of a government department, or a separate government agency, or a private or semi–private entity. Yet the aims of supervision will be similar and will include:

- Ensuring that the register is operated in compliance with legal and regulatory requirements and with the terms of the registrar’s appointment.
- Approving any changes to the specification of the registration system or to the operating procedures.
- Providing a review of any complaint made concerning the registry and of the way it is handled.
- Monitoring the financial operation and viability of the registry.
- Monitoring the technical performance of the registration system.
- Maintaining statistics of the register activity and performance for assisting in deciding future developments of the register, and more broadly in assessing trends in the secured credit market and the fulfilment by the register of its economic function.
- Maintaining an adequate back–up system to ensure that a reconstruction of the register at short notice would be possible in case of failure by the registrar. The person or body empowered with supervision should receive adequate reports and information and should be given the necessary powers of investigation to enable efficient conduct of the supervisory role.

Costs of registration

The system for registering and searching should be inexpensive, but fees have to be charged to recover at least the cost of operating the registry. Even if the cost is accepted as a direct cost of the state budget, the government is likely to want to recover some income from the registry. The essential criterion is to ensure that the registration fee is not so high that it acts as a barrier. The costs to be taken into account include not just the operating costs, but the costs of initial setting up of the registry, financing costs and costs of future enhancement and development. Effective cost controls are needed at all stages, and especially at the time of initial establishment of the register when costs are at their highest and there may be limited experience in assessing them. There can be many different options for the way the costs are reflected in the fees collateral by the registrar, but certain general study lines can be set:

- The fees should enable recovery of costs, including (if appropriate) the reasonable remuneration of the registrar. The fees should not be used as a source of taxation by government, or as a source of fat profits by a private registrar. Against that, the fees should not be set so low as to prejudice the financial viability of the registry.
- Fees may be collateral solely for making entries in the register (including amendments and cancellations) or for searches as well. Free searches would provide a positive image of the register and encourage its use. There are likely, however, to be a significantly greater number of searches than entries and they may thus represent a good potential source of income. In any event, the

search fee should be kept sufficiently low that it does not present a barrier to public access to the register.

- The registration fee may be a flat fee for all transactions or on a degressive scale varying according to the amount secured. A fee scale allows larger transactions to subsidise smaller ones, which can bring important benefits for small and medium-sized enterprises. However the maximum fee should be capped and, at all levels, the fees should be designed to be reasonable in the context of the transaction and not to act as a barrier to taking security.

- The financial performance of the registry should be subject to regular audit review to enable revision when appropriate of the fees collateral, and to ensure the transparency which is needed to maintain the confidence of the public (who will normally be predisposed to believe that fees are too high).

In summary

The development of a security right register will be an important aspect of the reform and the reform will be the most visible face of the reform to the general public.

The key decisions which need to be taken as soon as possible are:

- Which body will be best placed to develop and operate the registry, from a political, institutional and technical stand points.

- Whether registration of a security right should be dealt with in the same legal act as registration of immovable property.

Box 20: Features of reformed and unreformed systems for secured transactions in a nutshell – Publicity

Feature	Reformed systems	Unreformed systems	Economic effect of unreformed systems
Cost, accessibility and quality of registry	• Publicize security rights through a notice filing system that allows any potential lender to quickly determine whether collateral offered by a borrower has a prior security right. • Provide an Internet-based system for movable property collateral, allowing national and international access to notices of security rights. • Maintain filing archives that are user friendly, low cost, and quick. Typical cost in North America is between \$2.50 and \$15.00 per registration. • Require the filing of only minimal information about a security right (name, description, date of filing). • Permit but do not require the use of state and notary certifications.	• Require permission of authorities to access registry, and do not allow public access. May leave it up to judges to determine who can have access. • May have a registry that is not computerized. Registration systems may rely on antiquated filing methods, such as public announcements or newspaper advertisements. • May have a fragmented registry system, with multiple and unlinked registries in different jurisdictions. • Charge high fees for registration. Notary fees to process filings can range between 2% and 15% of loan value. Fees are charged monthly for inventory or accounts receivable financing.	• Where lenders do not have access to the registry system, they cannot verify their priority status. • Where there are multiple registries, lenders will not know which to search to discover what property a business has pledged. • Where registries are based on courts or notaries, determining priority can be impossible. • Filing becomes too cumbersome and costly relative to the value of loans, for both borrowers and creditors.
Advance filing and blocking	• Permit advance filings and reservation of a ranking of priority (“blocking”).	• May have no system for advance filings or for reservation of a ranking of priority.	• Between the time a lender checks for prior encumbrances against a potential borrower’s collateral and the time it grants the loan, another party could file a more senior security right against the same collateral.
Supply of registry services – public or private?	• Private companies authorized to operate a central database, with powers established by law. Requiring universal technical standards and non-proprietary software and hardware for the database can support competition.	• Have a registry that is run by the state or by a private monopoly as a state concession.	• Monopoly supply usually means high prices and poor service.

Source: *The World Bank – Reforming collateral laws (2006).*

4.5. Priority

The question of priority is at the very heart of what secured transactions are about. If the secured debt is not paid, the secured creditor should be able to have the security realized (regardless of who owns the assets at the time of enforcement), and to have the proceeds applied towards satisfaction of his claim prior to other creditors.

Accordingly, the law on secured transactions should establish rules governing competing rights of persons holding security and other persons claiming rights in the assets given as security.

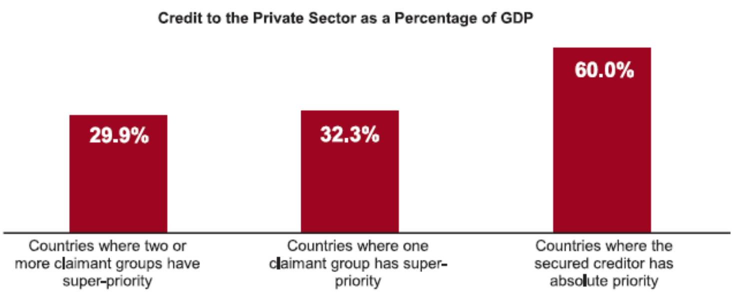
4.5.1. Basic rule: the security right that is first publicized has first priority (chronological rule)

One of the problems in a number of emerging markets as concerns secured transactions is that although it is, at least theoretically, possible to register a security right over movable property, the consequences of such registration and that of the lack of registration, are not clear. It seems that there are no consequences – the security right would nevertheless be valid and enforceable against all. This is essentially due to the lack of distinction between effectiveness vis-à-vis third parties (*opposabilité*) and priority. A security right can be effective vis-à-vis third parties, yet loose a contest of priority vis-à-vis another claimant over the collateral. Thus, two security rights may be granted over the same collateral, both be registered thereby becoming effective vis-à-vis third parties, but only the first to be registered would have priority. This has negative consequences:

- A prospective creditor has no way to ascertain whether or not the security right he intends to take over the debtor's property has already been granted as collateral in favour of another creditor. He must rely on the debtor's declaration, which always carries an element of hazard. When the time comes to enforce the security right, the secured creditor may find that another creditor had been granted a security right over the same assets before his own security right (based on the dates of the respective agreements).

- Third parties dealing with the debtor cannot ascertain whether the debtor's property is already attached as collateral or can be freely traded. This is problematic because the nature of a security right is that it attaches to the assets, even if they are transferred. This means that if the third party purchases the asset, that third party may one day find that a creditor had a valid, enforceable security right over this asset.

Box 21: Access to credit is greater when secured creditors have priority



Source: *World Bank Doing Business project database.*

Publicity, as described above, remedies both difficulties. Once registered, the security right becomes visible to all third parties, who can thus find out what property belonging to the grantor has been collateral. Conversely, a security right that would not be registered would not be opposable to a secured creditor with a registered security right. If several security rights have been granted over the same property, the order of priority is based on the time of registration.

As concerns possessory security, the transfer of possession would equally be treated as a means of publicity. So in the case where there exists a registered security right and a possession security right over the same property, the time of respectively registration and dispossession would determine the priority order between the secured creditors.

4.5.2. Exceptions to the chronological order rule

Sale of collateral in the "ordinary course of business"

It was mentioned in 4.1.3 of this paper that the scope of assets that can be collateral should be very wide, and in particular should include future and generally described property. Such property may actually be destined to be re-sold – this is typically the case of inventory held by a retailer for re–sale to customers. Whereas it is desirable to enable such an inventory to be the object of a security right, it is clearly undesirable that the security right is maintained over all and any of the inventory since it would mean that customers would actually purchase an item which could potentially be seized by the secured creditor through the *droit de suite*. Such a possibility would actually severely limit the trade that the grantor could do with the stock. This is why it is a typical exception included in secured transactions law that when collateral are sold "in the ordinary course of business" by the grantor, these assets are sold free from any security right.

In order for this exception to be successfully included into reformed secured transaction law, it will be important to determine correct interpretation that can be made in the law of the term "ordinary course of business". The exception should not be construed so widely that it would deprive the secured creditor from his collateral. It should not be so strict that it would not capture the cases where such exception would precisely be relevant.

Sale of collateral with the secured creditor's consent

It should always be possible for the parties to a security right agreement to agree contractually whether or not an asset can be sold by the grantor (assuming that this is outside the ordinary course of business). In particular, the wider the scope of the security right, the more important it will be that, during the life of the security right, the grantor can enter into transactions which may not be in the ordinary course of his business but would be commercially justified, as long as this has been agreed with the secured creditor.

Sale of collateral to a bona fide purchaser without notice of security right

In a system where non-possessory security rights must be registered to be effective against third parties, third parties are deemed to have been put on notice by the mere fact that the security right has been registered. It is not necessary to prove that the third party actually *knew* about the security right, it is sufficient that the third party could have known about it by searching the register. In such a case the third party is deemed by the law to have notice of the security right.

However, there may be (rare) cases where third parties had not been put on notice: for example, where the registration procedure had failed and the security right was not visible to a third party searching the register. Another case is that of the sale of an asset from A to B, which had been collateral to X. The security right was registered against A's name and thus B is deemed to have purchased the assets encumbered with the security right. However, if B re–sells the asset to C, without any change to the register that there is still a security right over the asset in favour of X, C would not be able to find the existence of such a security right. In such a circumstance it may be considered fair that C should not be affected by X's security right over the asset, on the condition that C purchased the asset in good faith, and did not know about the security right over the asset. A and B would however be liable to X for damages caused by the transfer of the asset.

Low value transactions

In some systems, a catch–all article is provided in the law that when the transaction over the collateral has a low value (e.g. less than 1,000 euros), the purchaser acquires the assets free from the security right. This has the advantage that it does not involve any legal concept – however the threshold must be carefully defined and also the risk of fraud must be assessed.

Purchase money security

A special case arises where a grantor who has previously granted a security right over all of his present and future assets, would want to finance the purchase of new assets. In such a case, a conflict arises between the need, on the one hand, to protect the rights of the existing secured creditor whose security covers after-acquired assets and therefore should have his security right covering the newly purchased asset too and, on the other hand, to ensure that an enterprise has access to the credit needed for the continuing conduct of its business.

For this reason the law often allows the financier providing finance to purchase the asset to gain priority over charges that are already registered. In practice this is achieved either by giving a special priority to new asset security (referred to as purchase money security rights in US based systems) or by allowing the seller to retain title to the asset sold until the price is paid (commonly used in European jurisdictions).

The economic pros and cons of facilitating purchase finance agreements in this way need to be weighed against the complexity that a purchase money security necessarily entails. For example, there may be a requirement to notify existing secured creditors who have security over After-acquired assets before the purchase is made (for example, when a replacement machine is acquired, the creditor who already has a charge over all present and future production machinery).

4.5.3. Exceptions to priority order that should be resisted

Priority ranking is to a large extent policy driven and it may be tempting to carve out exception to the chronological rule to favour certain groups of interest. These temptations should be resisted as much as possible as exceptions to the rule would affect the apparent certainty and reliability of a security, thereby potentially discouraging secured credit altogether.

- Judgment creditors may have a right to claim satisfaction from specific assets of a debtor (including those already attached as collateral at the time when the security right is rendered effective over that collateral). Any such right should be subject to registration in the security right register, and should only acquire priority from the time of registration.
- State creditors, such as the tax authorities, are sometimes given a right to recover their claims from specific assets of a debtor (including those already attached as collateral). Similarly, any such right should be subject to registration in the security right register, and should only acquire priority from the time of registration, but again this is not always the case.
- Possessory liens may arise in favour of persons who have a claim against the debtor in respect of services rendered in relation to the collateral (for example, a repairer's lien) are common and probably acceptable as long as the claim is clearly limited to services related to the collateral and not beyond.
- Priority should not be changed by bankruptcy or insolvency.

4.5.4. Particular rules relating to security right over receivables

Specific rules need to be provided in the case of security rights over account receivables, because of the specific nature of the collateral and the fact that a third party (the obligor) is involved.

- When account receivables are granted as collateral and are paid out to the grantor, the law usually provides that the security right is automatically transferred upon the proceeds of the claim (subject to the rules on tracing of proceeds, see above 4.1.3).
- The secured creditor should be allowed at any time to notify the sub-debtor about the security right's existence. In that event:
  - The sub-obligor's obligation can only be satisfied by payment to the secured creditor or to such person as the secured creditor nominates, and
  - The secured creditor may directly pursue the sub-debtor for that debt.
- If the sub-debtor pays off its money debt to the secured creditor, the secured creditor is entitled to keep the accepted payment as a payment toward or on account of the secured debt. If the secured claim is not duly and timely paid, the secured creditor is entitled to satisfy itself from the money performance of the sub-debtor, unless otherwise provided in the security agreement.

- If the payment by the sub-debtor accepted by the secured creditor exceeds the secured claim, the secured creditor must hand over to the grantor the amount exceeding the secured claim after deduction of reasonably spent expenses in relation to enforcement.

Box 22: Features of reformed and unreformed systems for secured transactions in a nutshell – Priority

Feature	Reformed systems	Unreformed systems	Economic effect of unreformed systems
Establishing priority	• Allow a creditor or seller on credit to establish a ranking among those who might have a claim against property offered as collateral, and make that ranking public. • Do not rely on a possessory system, in which the borrower must physically give the collateral to the creditor while the loan is outstanding (as with pawnshops or warehousing systems). • Use first-to-file basis to determine priority, and designate the place or means for making the security right public.	• Do not set clear rules for ranking priority among different creditors or different systems for registering security rights. • Often rely only on priority through possession, in which the borrower physically gives the collateral to the creditor. • Are unclear about how priority is determined when pledged goods are transferred from a non-possessory to a possessory system.	• Because lenders cannot determine their position in the ranking of claims against collateral, they cannot determine the value of a good as collateral. • Priority through possession can work for valuables and sometimes for inventory, but not for standing and future crops, equipment, fixtures, and vehicles. • Priority through possession limits the collateral that can be pledged because collateral, once possessed by the lender, becomes worthless to the borrower as a productive input.
Priority for future advances	• Set out priority rules for future advances. • For credit lines that are paid down and then drawn on again, extend the same priority to subsequent advances as was assigned to the initial advance.	• Do not set out priority rules for future advances. • For credit lines that are paid down and then drawn on again, do not extend the same priority to subsequent advances as was assigned to the initial advance. • Lead to ambiguous status for lenders extending a credit line once it is paid down.	• It is virtually impossible for lenders to safely offer revolving credit lines to borrowers. • Borrowers cannot access credit lines secured by second trusts. • Lending environment is less competitive. Borrowers are essentially tied to one lender, since second or third lenders will be less secure about their priority status.
Continuation in proceeds of a security right	• Permit a security right to continue indefinitely in proceeds, limited only by the ability to trace those proceeds. • Allow lenders to be confident of retaining their earlier priority and being able to have other private agents assist in collecting debt.	• Do not permit a security right to continue in proceeds, as when an asset, through its sale, is transformed into cash. • May permit partial continuation in proceeds – for example, covering the transformation of fertilizer into grain but perhaps not the transformation of grain into cash.	• Once a pledged asset is transformed (such as from fertilizer to grain, or from grain to cash), the lender must go to court to get a new security right in the transformed product. • Every time the lender goes to court, the lender faces risk of delay, risk of loss of priority to another lender, and additional costs. • The transaction costs and risks for lenders increase substantially.

Limits for fixtures	• Separate the framework for securing loans with movable property and fixtures from the framework for mortgaging the principal real estate.	• Treat fixtures as movable property until they are affixed to real estate, when they become subject to the legal regime governing real estate. • Consider pledged equipment, once attached to real estate, as subject to any mortgage against that real estate, so that the creditor loses priority status to the lenders holding the mortgage.	• No lender will finance the purchase or sale on credit of fixtures without also having a first rank security on the real estate to which the fixtures are attached. • No loans are likely to be made for furnaces, generators, and the like.
Rules for ranking priorit of tax claims and liens the state	• Assign priority to tax claims, liens, and state debts on the basis of the time of filing a notice in the public filing archive.	• Do not set out clear rules for ranking the priority of a security right relative to tax claims. • May create conflict between secured claims of private creditors and priority given by law for state tax liens. • Where state's claims are not public, make it impossible for potential lenders to tell in advance whether tax liens exist against collateral.	• The ability of the state to place its claims before those of private creditors, regardless of when or whether it filed the claims, fatally undercuts the secured lending system. • Laws contradicting one another compound lenders' uncertainty and thus lower the value of property as collateral.
Unified or multiple systems of establishing priority?	• Apply one system of priorities to all security rights as well as to all other transactions undertaken for security, including leases and conditional sales.	• Do not have a comprehensive priority system for all secured transactions. For example, leasing law might require registration in a different system than the one in which pledges are registered.	• Potential lenders that wish to take property as collateral need to check more than one system to learn of other encumbrances against the collateral.

Source: *The World Bank – Reforming collateral laws (2006).*

4.6. Enforcement

In the context of this paper, enforcement is the term used to describe the overall process by which a secured creditor obtains payment of the secured debt out of the collateral through enforcing the security right. It covers the procedural measures that have to be taken prior to a sale of the collateral, the steps needed to protect the assets pending sale, the sale or 'realization' itself and the distribution of the proceeds of sale.

The importance of an efficient enforcement procedure of a security right over property cannot be overstated. The strength of any system of secured credit lies in the confidence that the secured creditor can have in that enforcement right which he holds in reserve. The greater the confidence of the secured creditor that this will be the case, the higher will be the value that he will attribute to the security, and the cheaper and more available the credit will be.

Enforcement is often a difficult process in developing countries and all interviewed lenders complained about the process of trying to enforce a claim – secured or not. The main problems are:

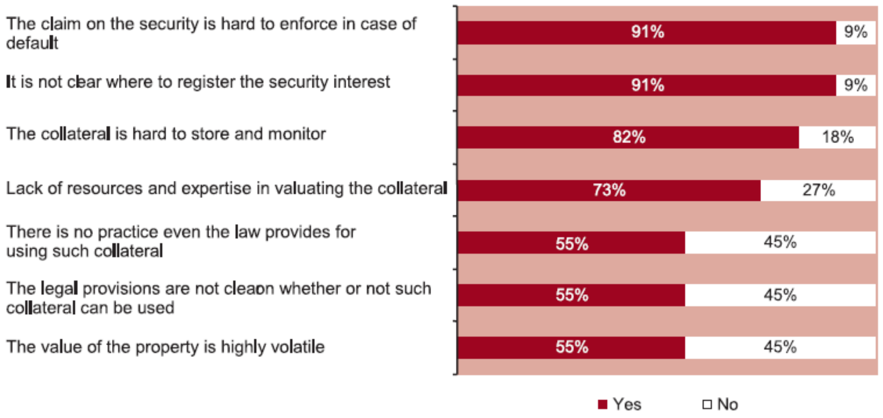
- The assessment of the value of the collateral before sale through public auction starts is often disputed, which delay the process.

- Obstructive debtors and no efficient legal means to prevent such obstruction.
- Conflicting or unclear legal provisions.

Out-of-court enforcement is an increasingly embraced trend precisely because enforcement requires a speedy and efficient judiciary, which is often lacking in developing countries.

It does not mean that out-of-court enforcement is the panacea: some jurisdictions who provide so have failed to gain benefits from it because their system depended on institutions, for example, bailiffs, who turned out to not be able to undertake the newly assigned tasks efficiently.

Box 23: Outcome of a survey in an Asian country outlining the reasons for not providing accounts receivable financing/factoring



Source: *IFC-VBA Financial Sector Survey.*

4.6.1. The trigger for enforcement

A security right is given to protect the creditor against a failure or default by the debtor to fulfill his obligation. It can only be enforced if and when such a failure or default occurs. It is therefore necessary to define precisely at what moment, and on the occurrence of what event, a security right becomes enforceable.

Failure to pay

The critical event for a security right to become enforceable is a failure by the debtor to perform (e.g., pay) all or part of the secured obligation. Whether or not there is a failure depends on the interpretation of the obligation underlying the debt. The moment that such a failure occurs, the security right should in principle become immediately enforceable.

Other events of default and acceleration

There are many other ways in which a debtor may fail to perform some of his obligations. For example, he may fail to maintain the collateral property or he may breach contractual undertakings given to the creditor. Such failure should not by itself automatically make the security right enforceable. Enforcement enables recovery of the secured debt and is only appropriate when the secured debt is immediately payable. Where the failure of the debtor is not a failure to pay, it has to be determined whether or not that failure causes the secured debt to become immediately payable, to be ‘accelerated’. If it does, then the secured debt will become enforceable immediately and enforcement of the security right will take place if there is a failure to pay the accelerated debt. There is thus a two stage default:

- First, there is a breach of a non-payment obligation which causes the secured debt to become immediately payable, and
- Second, there is a failure to pay the accelerated secured debt which renders the security right enforceable.

Curing the default

Enforcing a security right usually represents a dramatic method of obtaining payment. It implies that the debtor has failed to honour his obligations and enforcement will normally only be commenced if the creditor believes that it is necessary in order to obtain payment. In many cases it may be appropriate to allow a period during which the debtor has the opportunity to put right his failure before enforcement actually commences. It may also be desirable to allow for the remedying of ‘technical’ or unintentional breaches, for example where a bank through which payment is made fails to transfer funds in accordance with instructions. Thus, whereas the security right become enforceable immediately when failure to perform the secured obligation occurs, enforcement may well not be allowed to commence immediately but only after a delay has passed.

Recommendation: requirements for the law

A clear distinction has to be made between what is provided by law and what is agreed between the parties. It is preferable that the position under the law is kept simple and clear-cut. Any complexity under the law which gives scope to discuss whether or not a security right has become enforceable is likely to lead to uncertainty and reduce the value of the security right. For that reason provisions concerning acceleration and the remedying of breaches should be left for the parties to agree. The only essential requirements for the law are (i) a provision that the security right becomes enforceable immediately upon a failure by the debtor to pay all or part of the secured debt, and (ii) a provision that enforcement will cease immediately when the secured debt is satisfied in full.

4.6.2. The procedure for commencing enforcement

The procedure for commencing enforcement should be clear, simple and rapid.

Establishing the failure to pay

What is needed to establish that failure to pay the secured debt has occurred? At one extreme it may be argued that a declaration of the creditor suffices; at the other, it may be argued that a decision of the court is needed.

Many legal systems require an enforceable (or executory) title, i.e., an instrument which confers the right to proceed with enforcement. The court will check that the obligation was valid and that the debtor has indeed failed to perform accordingly. On this basis, enforcement can proceed.

Requiring a decision of the court is likely to add significant delay to the enforcement process, to place a heavy burden on the courts and to give unnecessary opportunity to a recalcitrant debtor to misuse procedure to his advantage. The idea is that the security right agreement could be in itself enforceable, as made compelling by the parties. It is desirable to find a procedure which minimises the need for court involvement while protecting the debtor against abusive practice by the creditor. In some jurisdictions, important categories of enforceable titles are so–called authentic documents, which is a way of “officializing” the document in order to remove the need of a court order when comes to enforce it. These bureaucratic requirements have to be measured against the real protection that they offer to the parties.

There should exist a rapid and effective procedure enabling the debtor to challenge the start of enforcement and, in addition, he should have the possibility of a separate action against the creditor for wrongful enforcement for damages suffered.

Notice to the debtor

The creditor should not be able to take any steps to enforce until he has given notice to the debtor (and to the grantor if a different person). The formalities of notice should be kept simple.

Publicity

It is also desirable that the commencement of enforcement should be publicized by registration in the security rights registry. It is relevant for third parties dealing with the grantor, for example persons who may be negotiating to give credit to the grantor, to know that enforcement has been commenced. It may also work as a leverage to encourage recalcitrant (or negligent) debtor to perform its obligation in order to avoid damaging publicity. Precisely, since enforcement publicity is likely to be damaging for the debtor, and it may be appropriate to introduce a specific right for the debtor to claim damages where such publicity is given wrongfully. For a possessory security right, no ready means exists for giving publicity. It can be argued that the need for publicity is less because the collateral are already out of the possession of the grantor, although the other arguments in favour of registration would still remain.

Notice to other secured creditors

Generally any requirement that notice is given separately to other persons who have a security right over assets of the grantor will be unduly onerous. However where a *prior* security right has been registered which covers the same assets as the security right being enforced, the enforcing grantor should be required to give notice to the prior grantor. In practice he will only be able to sell the collateral subject to the prior security right, and the grantor with the prior right should have the opportunity to decide what course of action to take.

Other formalities

Any other formalities for the commencement of enforcement should only be required to the extent that they are properly justified and they should be compatible with the concept of a simple, fast and efficient enforcement procedure.

NB: To some extent, the trend of the enforcement regime goes in parallel with the trend of the insolvency regime, i.e., out-of-court procedures where the parties (creditors and debtor) are encouraged to find a compromise and the court being involved only when such an agreement cannot be found or when some parties feel that their rights are not being respected. There is no reason why the enforcement regime should remain exclusively court-based when the insolvency regime has moved to a voluntary arrangement type of procedure.

4.6.3. Pre-realization

Protection of collateral

In practice, one of the biggest risks for the enforcing creditor is that the collateral somehow diminish or disappear prior to realization taking place. It is therefore desirable that, immediately upon commencement of enforcement, the enforcing creditor has a right to take possession of, or otherwise protect or freeze, the collateral. This right can be expressly agreed in the security agreement.

If the security right comprises goods that can be seized without entry on to the premises of the debtor, the creditor may use self-help, simply taking the goods. But otherwise, he will need the grantor’s co-operation.

If the grantor refuses to allow the creditor to exercise this right, there should be a simple and rapid procedure enabling the creditor to enlist the support of bailiffs or other persons with official powers to take possession of assets.

Right of challenge by the grantor

As seen above there should exist a rapid and effective procedure enabling the debtor to challenge enforcement. There is a danger, on the one hand, that the creditor will pursue enforcement wrongfully without regard for the grantor’s rights, and, on the other hand, that the debtor will use every ploy to impede enforcement. Both dangers can be reduced by providing sanctions but sanctions against the creditor are likely to bite harder since he will have a reputation to protect and may have more to fear from a claim for damages than a debtor who has already failed to pay his debt. It may therefore be preferable to place the burden of challenging enforcement on the grantor and providing evidence of such challenge, while giving him at the same time the right to pursue the creditor for damages for wrongful or abusive enforcement.

Rights of creditor against obstructive grantor

Where the grantor wrongfully impedes enforcement, for example by refusing to give up possession or by concealing collateral, the creditor should have the right to pursue the creditor for damages arising from such impediment and, in appropriate cases, to obtain a court order preventing the wrongful action continuing.

Delay prior to realization

Quite separately from any agreement between the parties to allow the debtor time to remedy a breach before enforcement can commence, it also has to be decided whether a minimum time has to elapse after enforcement has started (visible from the enforcement registration) before realization as such can commence. The advantage of such a delay is that it gives time to the grantor to challenge the enforcement and to prevent wrongful realization. The disadvantage is that it increases the opportunity for the grantor impeding enforcement and may reduce the likely proceeds of sale. Should such a delay be statutorily provided, it should be strictly limited and avoid be used to impede the process by allowing, for example, the grantor to request from the court successive postponements of the realization process.

4.6.4. Methods of realization

The objective of realization is for the secured creditor to obtain maximum proceeds with minimum delay. This is only likely to be achieved if:

- The procedures for sale are simple and cost-effective.
- The person responsible for selling has clearly defined obligations towards the secured creditor and the debtor.
- The procedures are flexible and permit the person responsible for selling to select the best commercial solution for the asset being sold given the particular circumstances of the sale.

Person or body responsible for the realization process

Broadly the choice is between the court or the secured creditor himself (or his appointee). Although it may appear to give greater protection if the court is given responsibility for the sale, this in practice rarely leads to a satisfactory result. The courts tend to be ill-equipped to organize commercial sales. It is often difficult to ensure that the persons to whom the court delegates the role have adequate incentives to achieve a good price with minimum delay and it is difficult to establish liability when the collateral is sold below market value or where there is unjustified delay. If the creditor is made responsible for realization, the incentive on him to realise a good price may depend on the amount of his claim. However this can be rectified by placing him under a clear liability towards the grantor and other secured creditors if he fails to do so.

Additional protection can be given by requiring, where appropriate, the involvement of market professionals (e.g. the sale of quoted shares by a broker, valuation of assets sold by private agreement) but the general objective of quick and fair process should remain.

(i) Sale by auction

Sale by auction may often represent the best and the fairest way of achieving a good result. Compliance with the detailed rules for an auction should not be an excuse for failing to achieve a good price. In each case the person responsible for the sale has to determine, using his commercial judgment, whether an auction is likely to be the best method of sale. The rules for auctions should be aimed at achieving the best price and should allow the collateral to be withdrawn from auction and sold privately if an appropriate offer is received prior to the auction.

(ii) Private sale

The problem with private sales is ensuring that they are carried on fair terms. For many assets this may be resolved by requiring the sale to be made by or through a market professional or on the basis of a professional valuation. A duty on the seller to realise a good price with minimum delay may also reduce the problem. The commercial reality of a voluntary sale by a debtor on the one hand, and a forced sale on enforcement on the other, should not be very different. The market for the assets is likely to be the same and there will be many cases when a private sale will achieve the best result.

(iii) Acquisition by the creditor

Many laws invalidate any advance agreement for the acquisition of the collateral by the creditor. There is a difference between the creditor acquiring the assets during the sale procedure, and the creditor keeping the assets in satisfaction of the secured debt. If the creditor acquires the collateral during enforcement he is simply being a purchaser like another and he, or the person responsible for the sale, should be under the same duty to realise a good price and to transfer the surplus price after payment of the secured debt and interests to the debtor. In practice the burden on the creditor of proving that a good price has been achieved may be more onerous.

(iv) Where several security rights exist on the same asset

The enforcing secured creditor should give notice to any prior-ranking secured creditor and should owe a duty to subsequent secured creditors to realise a good price. Where there is a prior-ranking security right the sale of the collateral will be subject to that security right unless the prior secured creditor is given the right to take over or join in the sale. Where there are subsequent security rights the proceeds of sale should be applied towards satisfying the other secured debts prior to being passed to the debtor.

Obligations and rights of parties to realization

The enforcement process involves parties the interests of which often diverge. It is important that the law identifies the rights and obligations of each of those parties, as follows:

- **Creditor** – an obligation to realise maximum proceeds with minimum delay; a right to apply the proceeds of sale to satisfy the secured claim.
- **Debtor** – an obligation to co–operate in order to facilitate the sale; a right to receive the balance of the proceeds after satisfaction of secured claims and costs.
- **Expert or person assuming responsibility for the sale** – may assume the obligation of the creditor or share it with him; will have a first preferential claim on proceeds for payment of fees.
- **Purchaser** – an obligation to pay the price in accordance with appropriate rules; a right to receive the collateral free from the security right; a right not to be challenged in his right of ownership even if the sale was not properly conducted unless he knew about the sale's impropriety or otherwise acted in bad faith.

Interference of insolvency proceedings

It is important to consider the co-ordination between the rules of enforcement and the insolvency proceedings, in particular whether enforcement proceedings will be suspended, should insolvency proceedings be opened at some stage in the process (that stage needs to be precisely defined); how the insolvency administrator or liquidator will conduct the realization process; whether a receiver can still pursue private sale whilst the insolvency administrator is in position, etc.

A fine balance must be struck between allowing enforcement to take place and the respect of orderly distribution among creditors and other stakeholders when the debtor is found to be insolvent.

4.6.5. Distribution of proceeds of sale of collateral

Person responsible

Normally the price will be paid by the purchaser to the person carrying out the sale. In the case of enforcement, there is a good case for requiring the proceeds to be distributed by an independent person in order to ensure that distribution is carried out correctly, especially when the sale is conducted by the creditor himself. The role of the person distributing the proceeds is to establish the entitlement of the different parties with a claim to the proceeds and to pay out them accordingly, and to return the surplus if any promptly to the debtor.

Duty to account

The person who distributes the proceeds should be under a duty to account to the secured creditor, other secured creditors and the debtor for the proceeds that have been received and the manner in which they are disbursed.

4.6.6. Requirements of law v. agreement between parties

It will never be possible for the law to envisage all the scenarios that may arise on enforcement. Beyond a certain level the inclusion of detailed provisions in the law may be counter–productive. It may add to the complexity of enforcement without necessarily bringing, in practice, any real advantage for either party. The reality of the secured credit market is that transactions are influenced by market forces and the parties to them need the greatest flexibility to adapt them to the circumstances. That applies as much to enforcement as it does to the initial creation of the security right. Where consumers are involved there is a need for rules to rectify the imbalance in bargaining power between creditor and debtor but that should be included in separate legislation designed to protect consumers. The secured transaction law should provide for a basic system for enforcement including the checks and balances to prevent abuse. Beyond that the parties should have the ability to agree the conditions applicable to enforcement between themselves.

Particular attention will be paid to the existing system's shortcomings and how they can best be addressed. If judiciary is perceived as a severe impediment, efforts will be made to ensure that the system is as remote from the judicial system as possible (within constitutional limits).

Box 24: Features of reformed and unreformed systems for secured transactions in a nutshell – Enforcement

Feature	Reformed systems	Unreformed systems	Economic effect of unreformed systems
Time frame for enforcing procedures	• Allow harmless repossession and creditor-administered sale of collateral. Through civil procedure law, provide for ex parte court orders (orders that can be issued even if the debtor is not present) to use force when necessary.	• In civil code systems, require a three-stage process for enforcement: the lender requests an order to execute from the court, a court official seizes the property, and the property is sold under a court-administered process of appraisal and auction. (In some common law systems a bailiff may reduce these steps.) • Involve costly court-administered procedures, with courts sometimes levying charges for each session.	• Systems result in court-dominated processes with uncertain outcomes, with judges interpreting the same laws in different ways. • Estimated time for execution ranges between one and three years, due to extreme backlogs of court cases.
Seizure of collateral	• Allow only proof that debt payment has been made as defense against seizure. • Have some exempt property provisions protecting against the seizure of certain property, but these strike a good balance between protecting the vulnerable and protecting the rights of creditors.	• Require that secured party have a court order for seizure. • Permit many challenges to the legal process, each of which can delay the order for seizure. • With a court order for seizure, require that court police seize property – but there are often few such officials and a low priority on rapid execution. • Strike a poor balance in exempt property provisions, with excessive protection of debtors (such as in preventing seizure of tools of a borrower's trade).	• Exempting equipment from seizure can cut off credit to small producers. Knowing that courts will not enforce the seizure of equipment, lenders will not accept it as collateral.
Sale of collateral	• Give parties freedom to agree on terms of sale for collateral. • Require creditors to notify debtors and junior secured creditors before sale of collateral. • Allow creditors to retain collateral in complete satisfaction of secured debt (strict foreclosure).	• Rely on complex, court-administered systems of appraisal and auction of collateral. • May forbid sale of collateral for less than amount of loan.	• Where enforcement (seizure and sale) takes one to three years, it makes most classes of movable property (accounts receivable, perishable goods) useless as collateral, because they do not maintain their economic value that long. • With costly court administered sales, lenders do not get paid and nothing is left over for debtors.

Source: *The World Bank – Reforming collateral laws (2006).*

4.7. Termination

A security right will normally be terminated by payment/satisfaction of the underlying money obligation, or other circumstances (e.g. sale of the collateral to the secured creditor; sale of the collateral in the ordinary course of business). By ‘terminate’ it is meant that the security right is no longer of any effect and the grantee has no further proprietary right, title or interest in the collateral property.

A secured transaction law must provide for termination. One incident of termination will require that the registration of the security right be removed from the register, as mentioned in §4.4 of this study.

4.8. Conflict of laws

The purpose of the reform is to assist States in the development of modern secured transactions laws with a view to promoting the availability of secured credit, thus promoting the growth of domestic businesses and generally increasing trade (see the introduction to this Study at §1). In order to achieve this purpose, a secured transactions law has to facilitate credit both from domestic and foreign lenders and from other credit providers, promoting the growth of domestic businesses and generally increasing trade. Increasingly, secured transactions law involves agreements between or affecting parties located in more than one State, or relating to assets that are meant for export or import, or are located in more than one State, or that are normally used in more than one State. To achieve comprehensiveness, the reform must address a broad range of issues that arise from various types of cross-border transaction.

This part of the Study discusses the rules for determining the law applicable to the creation, effectiveness against third parties, priority as against the rights of competing claimants and enforcement of a security right. These rules, generally referred to as conflict-of-laws rules, also determine the territorial scope of the substantive rules envisaged in the Study (i.e. if and when the substantive rules of the State enacting the regime envisaged in the Study apply). For example, if a State has enacted the substantive law rules envisaged in the Study relating to the priority of a security right, those rules will apply to a priority contest arising in the enacting State only to the extent that the forum State’s conflict-of-laws rule on priority issues points to the laws of that State. Should the forum State’s conflict-of-laws rule provide that the law governing priority is that of another State, then the relative priority of competing claimants will be determined in accordance with the law of that other State.

In an efficient secured transactions regime, conflict-of-laws rules applicable to secured transactions normally reflect the objectives of the secured transactions regime. This means that the law applicable to the property aspects of a security right should be easy to determine. Another objective is predictability. Conflict-of-laws rules should provide an answer to the question of whether a security right acquired under the law of State A remains subject to that law or becomes subject to the law of State B if a subsequent change in the connecting factor (for example, the location of the collateral) were to point to the law of State B for a security right of the same type. A third key objective of an efficient conflict-of-laws system is that the relevant rules should reflect the reasonable expectations of interested parties (i.e. creditor, grantor, debtor and third parties). In order to achieve this result, the connecting factor that indicates the law applicable to a security right must have some real relation to the factual situation that will be governed by such law.

4.8.1. Conflict-of-laws rules for the creation, third-party effectiveness and priority of a security right

The determination of the extent of the rights conferred by a security right generally requires a three-step analysis, as follows:

- The first issue is whether the security has been created.
- The second issue is whether the security is effective against third parties.
- The third issue is what is the priority ranking of the right of a secured creditor as against the right of a competing claimant.

Not all States draw a distinction between those three issues. In many States, a security right (or other property right) once created is by definition effective against all without any further action. In those States, the same conflict rule applies to the creation of a security right and its effectiveness against third parties (and priority may be analysed also as an issue of effectiveness (*opposabilité*)). Thus the same conflict-of-laws rule may apply to each of the three issues resulting in the substantive law of the same State being applicable to all such issues.

Therefore, the key question is whether one single conflict-of-laws rule should apply to all three issues. Policy considerations, such as simplicity and certainty, favour the application of only one rule.

Another important question is whether, on any given issue (i.e. creation, third-party effectiveness or priority), the relevant conflict-of-laws rule should be the same for tangible and intangible assets. A positive answer to that question would favour either a rule based on the law of the location of the grantor or a rule based on the law of the location of the encumbered assets (*lex situs* or *lex rei sitae*).

In the case of receivables, as intangible assets are not capable of physical possession, adopting the law of location as the applicable conflict-of-laws rule would require the development of special rules and legal fictions for the determination of the actual location of various types of intangible asset. For this reason, the Study does not consider the location of the asset as being the appropriate connecting factor for intangible assets and recommends an approach generally based on the law of the location of the grantor.

In addition, it is almost universally accepted that a possessory security right should be governed by the law of the place where the assets are held, so that adopting the law of the grantor for possessory rights would run against the reasonable expectations of non-sophisticated creditors. Accordingly, even if the law of the grantor's location were to be the general rule, an exception would need to be made for possessory security rights.

For all these reasons, the Study recommends two general conflict-of-laws rules on the law applicable to the creation, third-party effectiveness and priority of a security right, as follows:

- With respect to tangible assets, the applicable law should be the law of the location of the assets.
- With respect to intangible assets, the applicable law should be the law of the location of the grantor.

General rule: law of the location of the encumbered asset

The creation, the effectiveness against third parties and the priority of a security right in tangible assets are generally governed by the law of the State in which the encumbered asset is located. A frequent example of the application of this rule relates to security rights in inventory. If a grantor owns inventory located in a State that has this rule (State A), the law of that State will govern those issues. The rule also means that, if the grantor also owns other inventory in another State (State B), the relevant requirements of State B will have to be fulfilled in order for the courts of State A to recognize that the inventory located in State B is subject to the secured creditor's rights.

The general conflict-of-laws rule for tangible assets does not distinguish between possessory security rights and non-possessory security rights. Accordingly, the law of the location of the asset will generally apply, whether or not the secured creditor has possession of the asset. This is particularly relevant for intangible assets assimilated to tangible assets, such as negotiable instruments and negotiable documents. For example, the law of the location of the instrument or document will govern priority matters even if the security right is made effective against third parties otherwise than by possession.

Law applicable to the creation, third-party effectiveness and priority of a security right in intangible assets

In some States, the creation, third-party effectiveness and priority of a security right in intangible assets is governed by the law of the State in which the grantor is located. For example, if an exporter located in State A creates a security right in receivables owed by customers located in States B and C, the law of State A will govern the property right aspects of the security right.

In other States, the law of the location of the asset still governs the creation, third-party effectiveness and priority of a security right in intangible assets. In those States, it is necessary to establish the location of an intangible asset (e.g. for a receivable, the location of the debtor of the receivable).

The law of the grantor's location has several advantages over the law of location of the asset, especially where the encumbered intangible assets consist of receivables. One single law applies even if the assignment relates to many receivables owed by different debtors. In addition, the law of the grantor's location may be ascertained easily at the time the assignment is made, even if the assignment relates to future receivables or to receivables assigned in bulk. Moreover, the law of the grantor's location (place of central administration in the case of a grantor having places of business in more than one State) is the law of the State in which the main insolvency proceedings with respect to the grantor are likely to be administered.

It is also the case that, while the law of the location of the encumbered asset works well in most instances for tangible assets, great difficulties arise in applying the law of location to intangible assets, both at conceptual and practical levels.

Furthermore, even if a State had detailed provisions allowing a prospective or existing secured creditor to ascertain easily and objectively the law of the location of a receivable, practical difficulties would still ensue in many commercial transactions. This would be so because a security right may relate not only to an existing and specifically identified receivable, but also to many other receivables. Thus, a security right may cover a pool of present and future receivables. In such a case, selecting the law of location of the receivable as the law governing priority would not be an efficient policy decision, as different priority rules might apply with respect to the various assigned receivables. Moreover, where future receivables are subject to a security right, it would not be possible for the secured creditor to ascertain the extent of its priority rights at the time of the transaction, since the *situs* of those future receivables is unknown at that time.

In view of the above, the Study recommends that the creation, third-party effectiveness and priority of a security right in an intangible asset be governed in general by the law of the State in which the grantor is located.

4.8.2. Law applicable to the enforcement of a security right

In most States, procedural matters are governed by the law of the State where the relevant procedural step is taken. However, enforcement may relate to substantive or procedural matters. Although the forum State will use its own law to determine what is substantive and what is procedural, the following are examples of issues generally considered to be substantive:

- The nature and extent of the remedies available to the creditor to realize the encumbered assets.
- Whether such remedies (or some of them) may be exercised without judicial process.
- The conditions to be met for the secured creditor to be entitled to obtain possession and dispose of the assets (or to cause the assets to be judicially realized).
- The power of the secured creditor to collect receivables that are encumbered assets.
- The obligations of the secured creditor to the other creditors of the grantor.

With respect to substantive enforcement matters, where a security right is created and made effective against third parties under the law of one State, but is sought to be enforced in another State, the question arises as to the law applicable and thus the remedies available to the secured creditor.

One approach would be to refer enforcement remedies to the law of the place of enforcement, i.e. the law of the forum State (lex fori). The place of enforcement of security rights in tangible assets in most instances would be the place of the location of the asset, while enforcement of a security right in intangible assets such as a receivable might take place in the location of the debtor of the receivable. The policy reasons in favour of this approach are, among others, that:

- The law of remedies would coincide with the law generally applicable to procedural issues.
- The law of remedies would, in many instances, coincide with the law of the State in which the assets being the object of the enforcement are located (and could also coincide with the law governing priority if the conflict-of-laws rules of the relevant State point to such location for priority issues).

- The requirements would be the same for all creditors intending to exercise rights in the place of enforcement against the assets of a grantor, irrespective of whether such rights are domestic or foreign in origin.

On the other hand, selecting the law of the forum state may result in uncertainty if the encumbered asset is an intangible asset. For example, it is not clear where enforcement is to take place if the encumbered assets are in the form of receivables. The answer to this question could be very problematic as it would require the criteria for determining the location of the receivables to be set out. In addition, the secured creditor might be located in a different State at the time the initial enforcement steps are taken. In the case of a bulk assignment involving receivables owing by debtors located in several States, multiple laws may apply to enforcement. The difficulty would be the same if one enforcement act would have to be performed in one State (e.g. notification of the debtor of the receivable) and another act in another State (e.g. collection or sale of the receivable). If future receivables are involved, the secured creditor may not know at the time of the assignment which law would govern its enforcement remedies. All this uncertainty as to the applicable law may have a negative impact on the availability and the cost of credit.

A third approach would be to attempt to reconcile the benefits of the approaches based on the law of the place of enforcement and the law governing priority. Under this approach, the enforcement of a security right in tangible assets may be governed by the law of the place of enforcement, while the enforcement of a security right in intangible assets would be governed by the same law as the law that applies to priority. We recommend this solution as it preserves the benefits of using the law of the place of enforcement for tangible assets, while avoiding the difficulties that would arise if such law were to apply to intangible assets.

4.8.3. Impact of commencement of insolvency proceedings on the law applicable to security rights

Determining the law applicable to the creation, third-party effectiveness and priority of a security right and the post-default rights of a secured creditor may raise additional issues when insolvency proceedings are commenced in one State and some of the debtor’s assets or creditors are located in another State, or when insolvency proceedings are commenced in two different States owing to the multinational nature of the debtor’s business. In either instance, however, most States provide that general conflict-of-laws rules applying outside of insolvency proceedings would govern these matters, subject to the limitations discussed below.

Once, under the non-insolvency law applicable outside of insolvency proceedings by virtue of the conflict-of-laws rules of the forum State, the validity and effectiveness of a security right are determined, a second issue arises concerning the effect of commencement of insolvency proceedings on the priority of security rights. It is generally recognized that the insolvency law of the State in which the insolvency proceedings are commenced governs the commencement, conduct, including the ranking of claims, administration and conclusion of the proceedings. This may have the effect of changing the relative priority that a security right would have under secured transactions law, and establish categories of claims that would receive distributions ahead of a security right in insolvency proceedings. In addition, irrespective of priority issues a security right might be subject to the avoidance provisions of the insolvency law.

While the insolvency effects of insolvency proceedings on security rights typically are governed by the law of the place of insolvency, some States have adopted exceptions. For example, a forum State may defer to the insolvency law of the State in which immovable property is located for the insolvency effects on a security right in attachments to the immovable property. It is generally recommended that any exceptions to the applicability of the law of the place of insolvency should be limited in number and clearly set forth in the insolvency law.

4.9. Transition

All legislative action raises issues relating to the conflict of laws in time. Hence, most States have well-developed principles to determine, when a new law comes into force, its impact on inconsistent prior law and the extent of its application to existing legal relationships. Where, however, a major reform to existing law is contemplated, States usually incorporate into the reform statute specific rules governing conflict of laws in time as they arise in connection with the coming into force of the new law. These rules are typically known as “transition provisions”. In view of the scope of preceding chapters, the Study recommends that States adopt a series of transition provisions tailored to the new law they may enact.

The rules embodied in new secured transactions legislation reflecting the recommendations of the Study are likely to depart in significant ways from the rules in the secured transactions law predating the legislation. Those differences will have an obvious impact on any agreements that grantors and secured creditors conclude after the new legislation is enacted. However, many transactions concluded under the prior law will be ongoing when the new law comes into force. In light of the differences between the old and new legal regimes and the continued existence of transactions and security rights created under the old regime, it is important for the success of the new legislation that it contains fair and efficient rules governing the transition from the old law to the new law.

Two issues related to the transition from the old regime to the new law must be addressed:

- First, the new legislation should provide the date as of which it (or dates as of which its various parts) will come into force (the “effective date”).

- Second, the new legislation should also set forth the extent to which, after the effective date, the new legislation applies to transactions or security rights that existed before the effective date.

4.9.1. Effective date of new legislation

Prompt realization of the economic advantages of new legislation is a reason for States to bring the new law into force as soon as possible after enactment. These advantages must be balanced, however, against the need to avoid causing instability in, or disruption of, the markets that will be governed by the new legislation, and to allow market participants adequate time to prepare for conducting transactions under the new legislation, which may be significantly different from transactions under the prior law. Accordingly, and depending on the extent to which the new legislation had been the subject of public discussion (including substantial educational programmes for judges, lawyers and market participants), a State may conclude that the effective date of the new legislation should be some period of time after the enactment of the new legislation, in order for these markets and their participants to adjust their conduct in preparation for the new rules.

In determining the effective date, States might consider various factors including the following:

- The impact of the effective date on credit decisions.

- Maximization of benefits to be derived from the new legislation.

- The necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State.

- The status of the pre-existing law and other infrastructure.

- The harmonization of the new secured transaction legislation with other legislation.

- Constitutional limits, if any, to the retroactive effect of new legislation.

- Standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

States generally adopt one of three methods for bringing legislation into force at a date subsequent to enactment.

- First, it is provided that a law comes into force on a future date fixed by a “decree” or a “proclamation”.

- In other cases, the law itself will specify that future date. For example, if a law were enacted on 17 January of a given year, that law might simply provide that it comes into force on 1 September of the same year.

- In still other cases, the legislation will contain a specific formula for determining its effective date. For example, the law might provide that the effective date will be the first day of the calendar month following the expiration of six months after the date of enactment. A second formula might refer to the first day of January or July, whichever occurs first, following the expiration of six months after the date of enactment. Under a third formula, it is necessary to delay the effective date in order to allow time to build a technical infrastructure (such as a computerized registry). In these cases, States often use a “decree” to the effect that, for example, the date the registry becomes operational will be the starting point for the six-month or longer delay. The Study recommends that States either specify the effective date, or set out a formula for determining the effective date in the law itself.

As debts that are secured by rights in the grantor’s assets are often payable over a period of time, it is likely that there will be many rights created before the effective date that will continue to exist on and after the effective date, securing debts that are not yet paid. Therefore, States also must consider whether the new legislation should apply to issues that arise after the effective date when these issues relate to transactions entered into prior to the effective date.

One approach would be for the new legislation to apply prospectively only and, therefore, not to govern any aspects of any transactions entered into prior to the effective date. While there might be some appeal in such a solution, especially with respect to issues that arise between the grantor and the secured creditor, such an approach would create significant problems, especially with respect to priority issues. Foremost among those problems would be the necessity of resolving priority disputes between a secured creditor that obtained its security right prior to the effective date and a competing secured creditor that obtained its security right in the same encumbered assets after the effective date. Because priority is a comparative concept, and the same priority rule must govern the two security rights that are being compared, it is not practicable for the old rules to govern the priority of the security right of the pre-effective-date creditor and the new rules to govern the priority of the security right of the post-effective-date creditor. Determining which priority rule to apply to such priority disputes is not without difficulty. Applying the old rules to such priority disputes would essentially delay the effectiveness of some of the most important aspects of the new legislation, with the result that significant economic benefits of the new legislation could be deferred for a substantial period. The delay would affect all new transactions even though it would be needed for only some of the old transactions. Moreover, the delay would prevent parties with security agreements that cover future assets from taking advantage of the new law for assets acquired after its effective date. On the other hand, applying the new rules to such priority disputes might unfairly prejudice parties that relied on the old law (especially those parties that relied on the old law without notice that the law might be changed) and might also provide an incentive for such parties to object to the new legislation or advocate an unduly delayed effective date.

Alternatively, greater certainty and earlier realization of the benefits of the new legislation could be promoted by applying the new legislation to all transactions as of the effective date, but with such transition provisions as are necessary to assure an effective transition to the new regime without loss of pre-effective-date priority status. Such an approach would avoid the problems identified above and would otherwise fairly and efficiently balance the interests of parties that complied with the old law with the interests of parties that comply with the new law.

Taking into account these considerations, the Study recommends the second of these two general approaches:

- Immediate application of the new law to all transactions arising after its effective date.

- No general retroactive application of the new law to transactions entered into prior to its effective date.

- Application of the new law to issues and procedures (for example, priority disputes and enforcement mechanisms) arising after its effective date.

- Adoption of transition provisions to protect the rights that parties acquired under transactions concluded prior to the effective date.

4.9.2. Issues to be addressed by transition provisions

Many security rights created before the effective date of the new law will continue to exist after the effective date and may come into conflict with security rights created under the new law. Clear transition provisions are thus needed to determine the extent to which the rules in the new legislation will apply to those pre-existing security rights. These transition provisions should appropriately address both the settled expectations of parties and the need for certainty and predictability in future transactions. The transition provisions must address the extent to which the new rules will apply, after the effective date, as between the parties to a transaction that created a security right before the effective date. They must also address the extent to which the new rules will apply, after the effective date, to resolve priority disputes between a holder of a security right and a competing claimant, when either the security right or the right of the competing claimant was created before the effective date.

Disputes before a court or arbitral tribunal

When a dispute is in litigation at the effective date, the rights of the parties have sufficiently crystallized so that the coming into force of a new legal regime should not change the outcome of that dispute. It follows, therefore, that such a dispute should not be resolved by application of the new legal regime. Moreover, within the context of ongoing enforcement proceedings, parties to the dispute should generally not be able to avail themselves of mechanisms or rights provided in the new law. Litigation may involve matters other than enforcement. In these cases, ongoing litigation on one aspect of a secured transaction should not preclude the application of the new law to aspects of the transaction that are not the subject of litigation. Nor should it prevent parties from commencing litigation on any such matters under the new law.

Effectiveness of pre-effective-date rights as between the parties

When a security right has been created before the effective date of new legislation, two questions arise regarding the effectiveness of that right between the grantor and the creditor:

- The first question is whether a security right that was effectively created under the old law but does not fulfil the requirements for creation under the new law will become ineffective on the effective date of the new law.

- The second question is whether a security right that was not effectively created under old law but fulfils all the requirements for creation of a security right under the new law will become effective on the effective date of the new law.

With respect to the first question, different approaches are also possible. For example, a transition period might be created during which the security right would remain effective between the parties, so that the creditor could take the necessary steps for creation under the new law during the transition period. At the expiration of the transition period, if such steps had not been taken the right would become ineffective under the new law. On the other hand, a simpler approach (and the approach adopted by the Study) is to provide that, if a security right is created (that is, is effective between the parties) before the effective date of the new law, it remains effective between them after the new law comes into force.

With respect to the second question, consideration should be given to making the right effective as of the effective date of the new law, since the parties presumably intended the right to be effective as between them when they entered into their agreement. Nonetheless, some States address this issue by requiring a confirmation by the grantor that it intends the previously ineffective right to be effective under the new law. Such a requirement is difficult to put into practice, however, since it presumes that at least one of the parties knew of the defect, failed to do anything to correct it under the old law, but now wishes the security right to be effective. The more likely case involves the discovery of the defect after the new law came in force, in which case a rule providing for automatic effectiveness upon the coming into force of the new law is justified. This is the position recommended in the Study.

Effectiveness of pre-effective-date rights as against third parties

Different issues arise as to the effectiveness against third parties of a right created before the effective date of the new law. As the new legislation will embody public policy regarding the proper steps necessary to make a right effective against third parties, it is preferable for the new rules to apply to the greatest extent possible. It may, however, be unreasonable to expect a creditor whose right was effective against third parties under the previous legal regime of the enacting State to comply immediately with any additional requirements of the new law.

A preferable approach would be for a security right that was effective against third parties under the previous legal regime but would not be effective under the new rules to remain effective for a reasonable period of time (as specified in the transition provisions in the new law) so as to give the creditor time to satisfy the requirements of the new law. At the expiration of the transition period, the right would become ineffective against third parties unless it had become effective against third parties under the new law. In determining the length of time within which creditors are permitted to make their existing rights effective against third parties, States should consider a number of practical questions. For example, where a registry system for security rights already exists, a longer period might be contemplated since third parties would continue to have a means to determine if a security right encumbered particular assets. By contrast, where no registry system for security rights is in place, a shorter period might be considered (at least for rights for which a notice was not required to be registered under the old law), since third parties would not have an easy means to determine whether a security right encumbered a potential grantor's assets.

If the right was not effective against third parties under the previous legal regime, but is nonetheless effective against them under the new rules, the right should be effective against third parties immediately upon the effective date of the new rules. Once again, the presumption is that the parties intended effectiveness as between them, and third parties are protected to the full extent provided for in the new rules. This is the position implicitly recommended in the Study.

Priority disputes

Priority disputes necessarily involve applying one set of rules to two (or more) different rights created at different times. A legal system cannot simply provide that the priority rule in effect at the time when a security right was created governs priority with respect to that right because such a rule would not provide a coherent answer when one of the rights that is being compared was created under the former regime while the other was created under the new regime. Rather, there must be rules that address each of the following situations:

- Where both rights are created after the effective date of the new legislation.
- Where both rights are created before the effective date.
- Where one right is created before the effective date and the other right is created after the effective date.

The easiest situation is a priority dispute between competing claimants whose rights were created after the effective date of the new legislation. In that situation, it is obvious that the priority rules in the new legislation should be applied to resolve that dispute.

Conversely, if both of the competing rights were created before the effective date of the new legislation and the relative priority of the two competing rights in the encumbered assets was established before the effective date of the new rules and, in addition, nothing (other than the effective date having occurred) has happened that would change that relative priority, stability of relationships suggests that the priority established before the effective date should not be changed merely because the new law came into force. If, however, something occurs after the effective date that would have had an effect on priority under the previous legal regime (such as a security right becoming effective against third parties or ceasing to be effective against third parties), there is less reason to continue to utilize the former law to govern a dispute that has been changed by an action or event that took place after the effective date. There is a much stronger argument for applying the new law to such a situation. In other words, the existing rights of parties as they stood when the new law came into force are protected, but parties should not be relieved of the obligation to make certain that they avoid acting (or failing to act) in such a way that their existing rights are no longer preserved under the new law.

The most difficult transition situation involves a priority dispute between one right that was created before the effective date and another right that was created after the effective date. In such a case, while it is preferable to have the new rules govern eventually (indeed, sooner rather than later), it is appropriate to provide a transition rule protecting the status of the creditor whose right was acquired under the old regime, provided that creditor takes whatever steps are necessary to maintain protection under the new regime. If those steps are taken within the time prescribed in the transition rule, the new legislation should provide that creditor with the same priority it would have enjoyed had the new rules been effective at the time of the original transaction and those steps had been taken in a timely fashion under the old law.

Enforcement

Disputes may be in litigation at the date when the new law comes into force. Parties to the dispute should generally not be able to avail themselves of mechanisms or rights provided in the new law. For example, if non-judicial enforcement is prohibited under prior law, but authorized under the new law, enforcing parties should not be able to convert the judicial enforcement process into a non-judicial enforcement process. Likewise, within the context of ongoing enforcement proceedings, parties should not normally be permitted to invoke defences or other rights contained only in the new law.

Nonetheless, the vast bulk of disputes that involve transactions entered into before the coming into force of the new law will arise after the new law becomes effective. Two different situations can arise. On the one hand, it may be that secured creditors are entitled to exercise certain recourses and grantors are permitted to plead certain defences that are no longer permitted under the new law. On the other hand, it may be that the new law permits creditors to avail themselves of new remedies and permits debtors to plead new defences not previously permitted.

Where the new law abolishes certain remedies, or makes them subject to a new and more onerous procedure, there is an argument that creditors should not be prejudiced by the new law. For example, in some States, creditors in possession may, upon default, simply take the asset given in pledge without having to give notice to the grantor or third parties. The Study, by contrast, recommends that a creditor would have to give notice of its intention to accept the assets in satisfaction of the secured obligation.

A similar rationale applies to cases where grantors are deprived of defences or procedural rights that could be exercised under prior law. For example, in some States, grantors in default may suspend enforcement proceedings by remedying the particular omission that led to the default, thereby reinstating the secured obligation and stopping enforcement. The Study, by contrast, contemplates that grantors have a right to redeem the security by paying the outstanding obligation, but have no right to cure the default and reinstate the obligation.

In both these cases, there is an argument that the prejudice potentially suffered by a secured creditor or a grantor with the coming into force of the new law is sufficient to justify not abolishing any rights arising under prior law, even in respect of enforcement that commences after the new law comes into force. Both should be able to enforce the original agreement according to the law in force when it was concluded. By contrast, there is an equally strong argument that because the new enforcement regime results from a State carefully considering how best to balance the rights of all parties, it should apply to all post-effective-date enforcement remedies. This argument is particularly persuasive when the enforcement will affect the rights of third parties that have taken security rights in the assets after the new regime comes into force. Moreover, because the relative balance to be struck depends on the particular configuration of secured creditors’ enforcement rights and grantors’ rights in individual States under prior law, the Study adopts the general principle of immediate application.

As for the case where the new law provides creditors with new remedies, and grantors with new procedural rights, the argument for applying the new law to transactions existing prior to its coming into force is compelling. A secured creditor under prior law that has taken the steps necessary to ensure third-party effectiveness under the new law should be in no different a position than a creditor that initially takes security under the new law. Similarly, any new defences or procedural rights given to grantors and third parties under the new law should be available in connection with enforcement proceedings undertaken by all secured creditors, including those creditors enforcing rights arising under transactions that existed before the new law came into force.

Annex

Project needs and impact questionnaire

Based on an IFC model, below is a sample questionnaire that refers to the development in 3.2.1 of the study. It could be used at the beginning of the reform project. IFC also recommends using the sample two years after the completion of the reform project to assess the project impact.

A. CREDIT MARKETS

A. I. Volume of credit

1. Number of loans
   – Number of loans to private enterprises ____________
   – Number of loans to state-owned enterprises ____________
   – Number of loans secured by movables, of which: ____________
      Machinery and equipment ____________
      Means of transport ____________
      Agricultural products ____________
      Consumer goods ____________
   – Number of loans secured by immovable property ____________
   – Number of unsecured loans ____________
2. Credit to the Private Sector/GDP ____________
3. Average loan size, max and min amounts per product line: ____________
   – Factoring ____________
   – Inventory financing ____________
   – Car financing ____________
   – Car equipment financing ____________
   – Other ____________
4. Ratios of value of individual product line to total portfolio:
   – Factoring ____________
   – Inventory financing ____________
   – Car financing ____________
   – Car equipment financing ____________
   – Other ____________

A.II. Cost of credit

1. Average lending rate ____________
   – Average lending rate to private enterprises ____________
   – Average lending rate to state-owned enterprises ____________
   – Average lending rate for loans secured by movables, of which:
      Secured by machinery and equipment ____________
      Secured by means of transport ____________
      Agricultural products ____________
      Consumer goods ____________
   – Average lending rate for loans secured by immovable property ____________
   – Average lending rate for unsecured loans ____________
2. Spread between loans secured by real estate and loans secured by movables ____________
3. Spread between loans secured by real estate and unsecured loans ____________
4. Default rates:

   – Large borrowers ____________
   – Small borrowers ____________
   – State-owned companies ____________
   – Private companies ____________

B. LEGAL FRAMEWORK

B.I. Types of moveable collateral

Type of collateral	Financial institution Please indicate which of the following the financial institution accepts as collateral:		Legal review Please indicate whether the legal framework places any restrictions on the acceptance of the following as collateral:	
Tangible movable property				
1. Machinery and equipment	Yes	No	Yes	No
– Industrial and non-agro machinery	Yes	No	Yes	No
– Agro-machinery and equipment	Yes	No	Yes	No
2. Motor vehicles	Yes	No	Yes	No
3. Agricultural products	Yes	No	Yes	No
– Crops and other agricultural yields (plants and trees on land)	Yes	No	Yes	No
– Livestock, fish farm, etc.	Yes	No	Yes	No
4. Consumer goods	Yes	No	Yes	No
– Personal computers	Yes	No	Yes	No
– Furniture	Yes	No	Yes	No
Intangible movable property				
5. Investment property (stocks and securities, options and futures, derivative products, etc.)	Yes	No	Yes	No
6. Intellectual property (e.g. patent rights, trademarks)	Yes	No	Yes	No
7. Insurance policies	Yes	No	Yes	No
8. A single account receivable	Yes	No	Yes	No
9. Multiple accounts receivables	Yes	No	Yes	No
10. Inventory (i.e. goods for sale)	Yes	No	Yes	No
11. Membership and partnership interests in business entities and cooperative shares	Yes	No	Yes	No
12. Future (e.g. future crops, future acquisitions of collateral described in the agreement, and unborn livestock)	Yes	No	Yes	No
13. Other. Please Specify: ___________________________	Yes	No	Yes	No

B.II. Types of obligations

What obligations are capable of being secured?

(1) Present obligations?
(2) Future obligations?
(3) All the debtor's obligations?

B.III. Procedures for creation of security interests

What procedures / Formalities are involved in the creation of security interests

B. IV. Priority rules

In competing claims (multiple security rights on the asset) other than statutory claims (e.g. taxes, workers' salary, etc.), which secured creditor has priority?

First creditor to either register or take possession	Yes	No
First creditor to notarize	Yes	No
First creditor pursuant to the date of agreement	Yes	No
First creditor to provide finance	Yes	No
First creditor to register	Yes	No
Other		

B.V. Enforcement

1. Does the default rate vary by types of borrower? True False
2. Small borrowers have higher default rate than larger borrowers True False
3. Private companies have higher default rate than state-owned companies True False
4. Loans secured exclusively by immovable assets: ________________ (% of loan value)
5. Loans secured exclusively by movable assets: ________________ (% of loan value)
6. Unsecured loans: _________________ (% of loan value)
7. Loans secured exclusively by third party guarantees: __________________ (% of loan value)
8. What procedures are commonly followed to enforce secured claims:

8.a. Outside courts (e.g. informal workout, sale of credit to 3rd party)____ (% of the total enforcement cases)

8.b. Through courts but outside insolvency proceedings _____ (% of the total enforcement cases)

8.c. Through insolvency proceedings _______ (% of the total enforcement cases)

9. How long does it usually take to secure a default judgment on movable property collateral? ___________ months
10. How much does it usually cost to enforce secured claims? Court-related cost [______]% of the loan value
11. Taxes/fees incurred when collateral is sold by judicial auction. Please specify. ______
12. Are there simplified / summary proceedings for enforcing secured claims? Yes No

    If your answer is yes, please answer the following:

13. How often is a simplified / summary procedure used?
    - 13.1. Among State-owned enterprise clients _______________ % of the cases
    - 13.2. Among joint stock and limited liabilities enterprise clients ___________ % of the cases
    - 13.3. Among foreign-invested enterprise clients ______________ % of the cases
    - 13.4. Among individual borrowers ___________________% of the cases
14. Which cases are qualified to be processed through a simplified / summary procedure?
    - 14.1. The loan value is less than certain amount True False
    - 14.2. The ownership of the property is properly documented True False
    - 14.3. The security is properly registered True False
    - 14.4. The debtor is a sole proprietor or a household business True False
    - 14.5. Other, please specify
15. How long does it usually take to enforce a non-complicated movable security claim through a simplified / summary procedure? ___ months.
16. How much does it usually cost to enforce claims in a summary procedure? _____% of the loan value

17. What's the public perception on the following items:

	Completely agree	Basically agree	Basically disagree	Completely disagree
17.a. Law does not fit commercial needs	❑	❑	❑	❑
17.b.Law does not clearly establish priority rules among possible competing creditors	❑	❑	❑	❑
17.c.Immature market for movable assets (i.e. it is difficult to resell collateral)	❑	❑	❑	❑
17.d.Regulation is difficult or expensive	❑	❑	❑	❑
17.e.High court enforcement cost	❑	❑	❑	❑
17.f.Intervention from government	❑	❑	❑	❑
17.g.Long enforcement time	❑	❑	❑	❑
17.h.Complex enforcement process which requires creditor to first apply for a judgment and then apply to have judgment executed	❑	❑	❑	❑
17.i.Cumbersome judicial sale procedures which require appraisal and multiple auctions	❑	❑	❑	❑
17.j.Resources of judicial system is limited	❑	❑	❑	❑
17. k. Other, please specify	❑	❑	❑	❑

C. REGISTRY

C.I. Basic information on registry structure

1. Is there a unified registration and data storage for all security interests on movable assets at the national level? Yes No
   If yes, Number of security claims filed in the past 5 years
   Number of inquiries (to verify security interest)
2. If no, what are the means of publicising security interests?

C. II. Providing and accessing information in the registry

1.	Indicate the ways in which collateral can be registered and what percent of registrations (numbers of filings) are done by each means	Way to register	Available	%
		In-person	Yes	No
		Internet	Yes	No
		Fax	Yes	No
		Total	100%	
2.	Indicate the ways in which a security interest can be queried and what % of queries are done by each means	Type of Query	Available	%
		In-person	Yes	No
		Internet	Yes	No
		Fax	Yes	No
		Total	100%	

3. What are the restrictions on access to information in the registry? Mark all that apply.
   ____ No restrictions, all information is available to the public
   ____ Requires having the registration number or other pertinent information on the security interest
   ____ Requires signature of borrower
   ____ Requires signature of lender
   ____ Requires notary or lawyer to certify request
   ____ Other requirement___________________________

C.III. Time required to use registry

How long it takes (business days or hours) in terms of statutory limits and duration in practice to:	Statutory limits	Duration in practice
1. Register a security right for a piece of equipment, after the documents are delivered to the registry		
2. Register a security right for an automobile, after the documents are delivered to the registry		
3. Retrieve information from the registry to verify a security right		

C. IV. User fees and cost recovery

		To register a security interest	**To inquire about a sec. interest**
1.	Is there a fee?	Yes No	Yes No
2.	If there is a flat fee, please indicate amount and currency	Flat fee (amount):___________ Currency: _____________, as of ___________(date)	Flat fee (amount):_________ Currency: _____________, as of ___________(date)
3.	If the fee is a % of collateral value, please provide percent, and typical range of fee paid.	Percent of collateral: ______% Typical fee: __ Less than US$ 10 __ Between US$ 10 and US$ 50 __ Between US$ 51 and US$ 100 __ Between US$ 101 and US$ 250 __ More than US$ 250	Percent of collateral: ______% Typical fee: __ Less than US$ 10 __ Between US$ 10 and US$ 50 __ Between US$ 51 and US$ 100 __ Between US$ 101 and US$ 250 __ More than US$ 250
4.	If the fee is determined in another manner (neither flat fee nor % of collateral) describe fee basis below and give typical fee range. <u>Fee basis:</u>	Typical fee: __ Less than US$ 10 __ Between US$ 10 and US$ 50 __ Between US$ 51 and US$ 100 __ Between US$ 101 and US$ 250 __ More than US$ 250	Typical fee: __ Less than US$ 10 __ Between US$ 10 and US$ 50 __ Between US$ 51 and US$ 100 __ Between US$ 101 and US$ 250 __ More than US$ 250
5.	Do fees vary by way of accessing information – i.e. by internet, in person, by phone	Yes No If Yes indicate most, least expensive Most: Least:	Yes No If Yes indicate most, least expensive Most: Least:
6.	Does the registry cover its cost of operations?	Yes No	
7.	If the registry doesn't cover its costs, who covers the shortfall?	_________Government (Please specify what agency / ministry)______________ _________Affiliated organization (Please specify organization)______________ _________Registry is in debt	

C. V. Operations / Procedures

1.	Registration requires completion of an application for registration form	True False
2.	Registration requires notarization of one or more registration documents	True False
3.	The registry officials review the authenticity of the information in the security agreement and principal agreement before registering a security right	True False
4.	The registry guarantees the validity or legality of the security right or agreement registered	True False
5.	Registration requires the signature of the debtor	True False
6.	Registration requires the signature of the creditor	True False
7.	Registration requires specification of the value of the obligation for which security is granted	True False
8.	Registration requires specification of the value of the security property (or collateral)	True False
9.	Valuation of security interest by a third party is mandatory	True False
10.	Amendment to registration requires physical presence of both parties of the contract in the registry	True False

C. VI. Problems with the registry

	Yes	No
1. It requires very specific description of collateral, so precludes securing collateral that may change over time	❑	❑
2. It requires documents proving the ownership or right to use of collateral, but it is not very clear what type of proof can be used	❑	❑
3. It is difficult to determine the place to register	❑	❑
4. Documentation requirements are excessive and burdensome	❑	❑
5. Registration requires determination of the value of the collateral, making it impossible to secure interests in collateral that varies in value	❑	❑
6. Registration is only issued after substantive review, which is complicated and time-consuming	❑	❑
7. Historical registration records are incomplete and hard to search	❑	❑
8. Information in the registry is not readily available to all who may need it	❑	❑
9. It takes too long for a registration to be processed	❑	❑
10. Fees are too high	❑	❑
11. Requirements and procedures differ between offices of the registry	❑	❑
12. Registration and searching cannot be done on-line, but require a visit to the office of the registry	❑	❑
13. There is no unified registration and data storage system	❑	❑

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