Secured Transactions & Insolvency – Importance & Best Practices

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September 22, 2010

Agenda

- **Introduction**
- Secured Transactions
- Insolvency
- Conclusion

Better Business Environment and Investment

Investment is predicated on both **perceptions of risk** and the **reality of risk**

How to Attract Investment?

Manage/Reduce RISK!

Better Business Regulations
Better Implementation → **Lower Risk** → **Higher Investment** → **Economic Growth**

The Business Environment

Business Entry

Business Operations

Tax

Trade Logistics

Investment Policy

Financial Regulations

Credit Bureau

Leasing

Payment Systems

Mortgage Finance

Corporate Governance

Labour Policies

Infrastructure

Skills

Technology

Quality Standards

Dispute Resolution

Secured Transactions

Insolvency

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Secured Transactions - Definition

- A loan or a credit transaction in which the lender holds an interest in a debtor's moveable property ("collateral") to secure a loan or a debt obligation.

- The Creditor is entitled to foreclose on or repossess the collateral in the event of the borrower's default.

- The interest in the moveable property is referred to as "security interest" or "pledge" or "charge".

- The terms of the relationship are governed by a contract or security agreement.

Why is Collateral Important?
Four C’s of Credit

- Character
- Cash Flow
- Capital
- Collateral

Why is Collateral Important? Four C's of Credit

Character

No/inefficient credit bureaus

Cash Flow

No/poor financial statements

Capital

How do we prove net worth?

Collateral

Why is Collateral Important?

Decreases the Cost of Credit:

In developed systems, borrowers with collateral get 9 times more cash, repayment periods of up to 11 times longer, and interest rates up to 50% lower than borrowers without collateral.

Increases the Level of Credit:

In developed systems, credit to GDP averages 60% compared to 30% of average for countries without a clear creditor protection system.

Why Focus on Moveable Assets?
SMEs as the Machine of the Economy - Jordan

Sole Proprietors	Limited Liability Companies	Number of Partnerships	
		General	Limited
306,074	20,801	97,151	15,261

Why Focus on Moveable Assets?
SMEs as the Machine of the Economy - Syria

Sole Proprietors	Limited Liability Companies	Number of Partnerships	
		General	Limited
380,942	367	79,625	17

SMEs benefit the most from a secured transactions reform

Why a Secured Transactions System is Important?

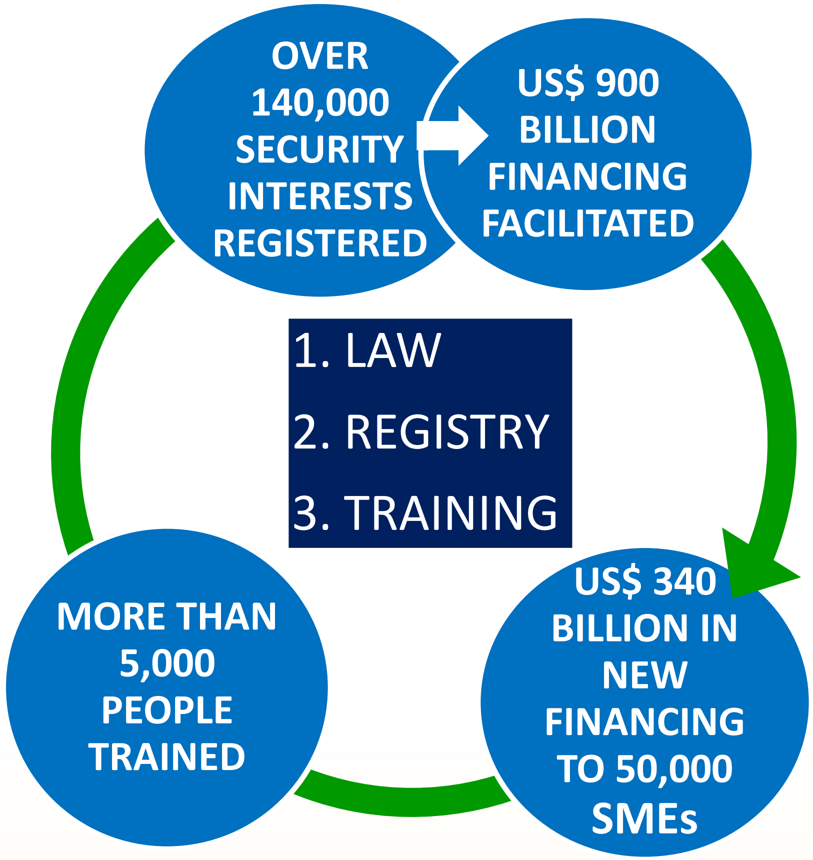
Modern Secured Transactions Systems strengthen financial systems by:

- **Diversification of assets held by financial institutions** as to more efficiently spread risks;
- **Reducing concentration in the financial system**, by providing banks with profitable lending opportunities in the SME sector (so they can expand their activities beyond corporate);
- **Improved liquidity of assets**, especially short-term assets such as accounts receivable;
- **Increased competition for financial services** by enabling NBFIs to offer secured loans.

China: the results of a targeted reform program

Reforms

LAW (2007)	Provided input to the law to: - Allow accounts receivable to be used as collateral - Grant equal treatment for individual lenders and legal entities - Allow use of future property as collateral
REGISTRY (2007-2008)	Designed and implemented an electronic registry for accounts receivables
TRAINING	5000 government officials and bankers trained



What is a Good Secured Transactions Law?

- **Scope** – Encompasses all types of transactions that in function secure an obligation by moveable assets

- **Creation** – Types of assets that can be used as collateral; types of entities that can use their moveable assets as collateral

- **Registration** – Centralized, electronic, affordable, easy-to-access (register and search), reliable, modern, secure collateral registry

- **Priorities** – Secured Creditors to have as high of a priority as possible

- **Enforcement** – Allow out-of-court/simplified procedures for enforcement

Risks Associated with Using Moveable Assets as Collateral

- The law limits the use of certain types of assets as collateral
- There are no well-functioning collateral registries
- Movable assets move - Collateral can be modified, parted out, hidden, moved to another country, sold without paying off the creditor
- Law enforcement and court systems are weak
- There are no Credit Bureaus
- No appropriate system of asset valuation
- Corruption to the detriment of lender

Education Needed

- Banks and MFI’s
- Regulatory teams
- Auditors
- Courts – judges
- Borrowers
- Vendors

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Where Secured Transactions and Insolvency Intersect

A degree of harmonization / consistency may be required in the design of both the secured transactions and insolvency regimes to ensure clarity and avoid a mismatch of incentives. Outside of insolvency, secured creditors rely on their contractual rights as between private parties. *Inside* insolvency, however, the private relationship becomes a ‘public process’.

Link Between Secured Transactions and Insolvency

- Insolvency is a vital part of the creditor-debtor regime in a country and, as such, supports predictability in credit markets.

- An insolvency regime should recognize and support the continuation of pre-insolvency rights of creditors in relation to their assets.

- Insolvency laws can undo the gains of secured transaction laws.

What is Insolvency About?

- Rehabilitation of viable yet-troubled businesses
- Efficient liquidation of non-viable ones

Maximizing value of Assets

What is a Good Insolvency System?

Though country approaches vary, effective insolvency systems should aim to:

(i) Maximize the value of a firm's assets and recoveries by creditors;

(ii) Provide for the efficient liquidation of both nonviable businesses and those where liquidation is likely to produce a greater return to creditors and the reorganization of viable businesses;

(iii) Strike a careful balance between liquidation and reorganization, allowing for easy conversion of proceedings from one procedure to another;

(iv) Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors;

(v) Provide for timely, efficient, and impartial resolution of insolvencies;

…What is a Good Insolvency System?

(vi) Prevent the improper use of the insolvency system;

(vii) Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments;

(viii) Provide a transparent procedure that contains, and consistently applies, clear risk allocation rules and incentives for gathering and dispensing information;

(ix) Recognize existing creditor rights and respect the priority of claims with a predictable and established process;

(x) Establish a framework for cross-border insolvencies, with recognition of foreign proceedings; and

(xi) Establish a developed system of informal workouts.

…What is a Good Insolvency System?

Institutional Considerations:

❑ Courts

❑ Insolvency Practitioners

Independence
Integrity
Capacity
Competence

Snapshot of Insolvency Practices in the Region

- Some countries do not have a restructuring law.
- Recent trends show that there has been a recent call to modernize bankruptcy regimes.
- Several countries' laws allow "traders" or "merchants" to file, whether they are companies or individuals, thus expanding access beyond corporate entities.
- State-owned companies, however, are frequently excluded from bankruptcy proceedings.
- Creditors can file for bankruptcy in most of the countries.

Liquidation

- The majority of insolvencies are liquidations.
- Delay and inefficiency strain the effectiveness of insolvency systems.
- Efficient recovery and maximization of assets is not the norm. Bankruptcy is a last resort.
- Criminalization of insolvency/bankruptcy, and the fraud suspicion toward debtors, slow down proceedings in the region (i.e. dishonored cheques).

Reorganization

- There are few reorganizations, even if the countries have reorganization provisions in their laws. Limitations to reorganization include:
  - A lack of expertise on corporate rescue
  - Institutional capacities limit restructuring. Courts and professionals must be more flexible.
  - A need for realistic timelines, provisions for disclosure of debtor financial information, provisions for operating funds through priority for post-petition financing.
  - A lack of provisions for the preparation of a plan of arrangement and the ability to obtain financing during the reorganization.

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Improving the Business Environment Should be Comprehensive

A mortgage law reform could facilitate the use of immoveable assets as collateral

Without good titling and property rights systems, assets cannot be used as collateral

A secured transactions reform could facilitate the use of moveable assets as collateral by businesses in the formal sector

A credit bureau reform could allow businesses in the formal sector to develop a credit history, and gain access to unsecured credit or secured credit at better terms

Without good entry systems, businesses will remain in the informal sector, and cannot take advantage of the benefits of these reforms

Without good trade logistics and laws that would allow assets to be transported and sold in other markets, creditors , especially where domestic markets are small, will have difficulties selling many of the foreclosed assets, and will, therefore, be reluctant to take such assets as collateral

Countries with Better Overall Business Regulations Grow Faster

Methodology

Doing Business data from 135 countries and seven regulatory areas: starting a business, hiring and firing workers, registering property, getting bank credit, protecting equity investors, enforcing contracts in the courts, and closing a business.

Data on average annual growth of GDP per capita between 1993 and 2002 from the WDI.

Results

The relationship between more business-friendly regulations and higher growth rates is consistently significant in various specifications of standard growth models

Improving from the worst quartile of business regulations as captured by Doing Business to the best implies a 2.3 percentage point increase in annual growth

Djankov, McLiesh, Ramalho, “Regulation and Growth”, The World Bank, March, 2006

Credit Constraints are a Barrier to the Entry of Small Firms

Methodology*

Harmonized firm-level data for 16 industrialized and emerging economies were used

Firm size is determined based on the number of employees classified as 1-19 workers, 20-49 workers, 50-00 workers, 100-499 workers, and 500 or more workers

Data in the study excluded single-person businesses

Industries excluded are agriculture, mining, manufacturing, electricity, gas, water supply, financial intermediation, community, social and personal services

Results*

In industries that rely more heavily on external financing, removing credit constraints increases the entry of new firms.

Failing to improve conditions for entry at the same time would hinder the creation of these new firms.

*Scarpetta, "Credit Constraints as a Barrier to the Entry and Post-Entry Growth of Firms", OECD, December, 2007
**APEC Economic Committee, "The Ease of Doing Business in APEC: The Impact of Regulatory Reforms", June, 2010

BUSINESS & DELIVERY MODEL

	DIAGNOSTIC What is wrong?	SOLUTION DESIGN How to fix it?	IMPLEMENTATION Making it happen
LAW	No laws, complex / conflicting laws	Drafting, revising harmonizing the legal framework	Enacting new laws. Intensive consultations to meet legislative agenda
REGISTRY	No registry or paper-based, dysfunctional registry	Creation of new registry or registry redesign, shift to electronic platform	New electronic / web based registry. Study visits, training, live demonstrations of registry, access points
CAPACITY	Little or no movable asset financing	Focus on raising awareness, building partnerships with private and public sector	Training of FIs and NBFIs. Workshops, conferences, media outreach, lending survey

Stakeholder Management (client: government + beneficiaries: FIs and NBFIs)

M&E

Insolvency TA's Menu of Worksteams

Reforming the enabling Environment

Developing and implementing the insolvency practitioner regulatory framework

Developing and implementing rules and guidelines for out of court workouts

Increasing the capacity of institutions that implement the insolvency framework

Thank you!!!

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