

Social Finance Programme

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Collateral, Collateral Law and Collateral Substitutes
(2nd Edition)

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Introduction

The collateralization of loan contracts is at the intersection of several fields: in financial sector development, the possession of collateral largely determines whether certain categories of economic agents obtain access to the financial market and whether financial contracts are efficiently concluded, i.e. with least losses. Collateral issues are also relevant in targeted promotion strategies, like small enterprise and private sector promotion, respecting poverty alleviation. Some successful major micro-finance programmes have developed original approaches to collateral.¹ Collateral issues attract therefore the interest of a broad range of agencies in the development community.

The purpose of this report is to tie together ongoing conceptual and field work on collateral law and substitution, to identify the outstanding issues, especially those relevant for policy-making and institutional learning and to formulate recommendations for donor agencies interested in the financial sector in developing countries and transition economies. The ultimate goal of this report is to influence policies, the regulatory framework and institutional behaviour with a view to innovative and effective collateral substitution. This would contribute to removing what is considered to be an important obstacle in the access of the poor to financial services.

The report is organised in 5 sections: the first part explores the extent and nature of the collateral constraint. The second section seeks to throw light on what is meant by collateral, collateral law and collateral substitutes and their respective functions. The third section reviews the available empirical evidence on the effects of the legal and regulatory framework and on the performance of substitutes. The fourth part summarizes findings. The report concludes with policy issues and points for discussion.

There has been some controversy over the incidence of collateral on the access to financial services, especially of small and micro businesses. This debate would seem to justify a brief review of the functions of collateral in loan contracts. The notion "collateral substitute" has been around for some time in the donor community, a "catch-all" notion to describe a variety of techniques to resolve a shortfall in real, tangible assets to secure a loan. Therefore, a more rigorous examination of the notion "substitution" seemed to be called for. Another concern of this report is the statutory environment of collateralization; the very notion "collateral law" signals that the difficulties are closely related to the legal and regulatory framework within which loan contracts – secured or unsecured – are concluded.

¹ To the point that some donor agencies like USAID require "additional evidence from a financial institution . . . that it is actually reaching poor customers . . . (if) it does not rely on collateral substitutes."

The practical interest of this report is embodied in two assumptions:

- a simplification of the formal rules to create, perfect and enforce security interests and a greater transparency in registers will reduce overall transaction costs in loan securization and thus lead to an increased flow of finance to investment-seeking (small) borrowers; and
- if banks were better informed about the merits of collateral substitutes, they would increasingly secure loan contracts in this way thus stimulating a flow of investable resources to market participants that would otherwise have gone without them.

If these assumptions are valid, then in the first instance public authorities would be called upon to alter the conditions under which loan contracts are secured (collateral law); in the second instance, banks and other financial institutions would be invited to learn how to adjust their lending technology (collateral substitutes).

1. Is lack of collateral a constraint?

Collateral is an asset pledged by a borrower to a lender until a loan is paid back. If the borrower defaults, then the lender has the right to seize the collateral and sell it to pay off the loan.

Lack of collateral is said to explain the mismatch between supply and demand in the small-scale financial market.² The risk perception by banks of small enterprise lending – whether justified or not³ – and the absence of risk guarantee institutions seem to have contributed to the segmentation of financial markets in many developing countries (J. Levitsky, 1993, pp. 9-10 and W. Schneider-Barthold, p. 51). "The provision of collateral by the target group has posed a significant problem to those projects involving banks" (USAID).⁴ "Lack of collateral satisfactory to banks has almost always been a constraint on disbursement of World Bank SME lines of credit" (Steel).

1.1 A constraint for whom?

It is plausible to think that the lack of collateral is primarily a constraint for the borrower, i.e. in terms of market access limitations: "this reliance on real estate as collateral means that one quarter of Argentine farmers that own no land will have no access to formal credit" (Fleisig, 1994, p. 3). However, not all undercollateralized borrowers are necessarily constrained in their access to financial services, only those that seek formal bank credit, for example SME targeted by credit lines operated through the banking system. For borrowers outside of the formal banking sector, "particularly micro enterprises this is much less of a constraint" (USAID), or in connection with "revolving funds and income-generating credit schemes as part of social funds and welfare-oriented projects . . ." (Steel).

Also, undercollateralization is not exclusively a problem for the borrower. A bank could also conceive as constraining the lack of collateral, namely when a borrower's credit application meets all other criteria except the bank's collateral requirement. In this case, the bank would be obliged either to take the risk of uncollateralized exposure or accept a less preferred form of collateral implying possibly higher costs in establishing and enforcing security interests. Sometimes a bank can compensate for these increased risks and costs by charging correspondingly higher interest rates; sometimes it cannot do so because of interest rate ceilings, in which case the bank is doubly constrained by a lack of collateral and interest rate policy.

² The notion "small-scale financial market" is to encompass SMEs, micro-enterprises, small farmers.

³ That the risk perception is often not supported by statistics is borne out by comparing overall default rates with SME portfolio default rates within the same banks (Koch, annex A-52, table).

⁴ Quotations without reference relate to a survey response. For complete text refer to the annex.

If, because of a lack of collateral, a large number of loan contracts are not concluded, then Central Banks and other authorities responsible for the efficiency and security of transactions in the financial market and for a broad-based participation of the largest possible number of households and enterprises have a reason to be concerned, as well. The social costs of collateral-related problems in terms of higher interest payments, a reduced volume of investment and lower output levels (Fleisig, 1994, p. 3) does therefore call for the attention of public authorities.⁵

1.2 Causes for the collateral constraint

Four explanations have been advanced:

– *Suboptimal asset distribution*

The first explanation is to say that the asset distribution is suboptimal; if more Argentine farmers owned more than 100 hectares, then they would have obtained more loans, more investments would have been made, etc. According to this view, assets would need to be redistributed more equitably; land reform would make the search for collateral substitutes redundant;

– *Inappropriate legal and regulatory framework*

According to the second view, there is nothing fundamentally wrong with asset distribution, but with the legal and regulatory framework governing financial contracts and especially their collateralization; Fleisig and USAID, for example, argue that if one removed legal restrictions on the use of moveable property for collateral purposes or if one made real estate and commercial registries more transparent, up-to-date and accessible, then more "security interests" would be established at no supplementary risk to banks, hence more loan contracts would be concluded and more output produced;

– *Repressive monetary and especially interest rate policies*

Another way to look at the collateral constraint is to say: the legal and regulatory framework itself is not a constraint, but certain monetary and credit policies by the Central Bank, especially interest rate ceilings that make it impossible for banks to charge the extra risk premium to undercollateralized clients. However, this view presupposes that banks have the "right" risk perception;

– *Uninformed banks*

The fourth position questions the risk perception by banks. They are basically poorly informed. Banks exaggerate the likelihood of default of particular classes of borrowers, hence impose unrealistically high collateral requirements, which results in credit-rationing (Stiglitz/Weiss, 1992, p. 718).

⁵ World Bank (1994, p. III) in fact estimates that collateral problems cost the Bolivian economy 3-4% of

Whatever the precise cause, it has also generally been argued that the collateral constraint is a false problem in the sense that banks use it as a pretext not to have to deal with SMEs. By hiding behind the collateral issue, they deflect the criticism that they are "not doing enough for small businesses", while in reality the transaction costs involved or other problems are the real constraints. Indeed, collateral is not the only constraint. Sprenger (pp. 15-16), for example, in a systematic overview of the factors determining the financing situation of small enterprises identifies collateral just as one of six enterprise-internal factors (in addition to the legal form, size, sector, financial management). Koch's survey of commercial bank appraisal criteria in Ecuador, Colombia and Peru (pp. 318-323) found that the availability of collateral was not the most important criterion, and that the track record, the transparency of financial management and the borrower's position in the market ranked higher. Whether lack of collateral is indeed a false problem for banks is difficult to say; but that it is perceived to be a problem by borrowers is without any doubt and justifies further investigations.

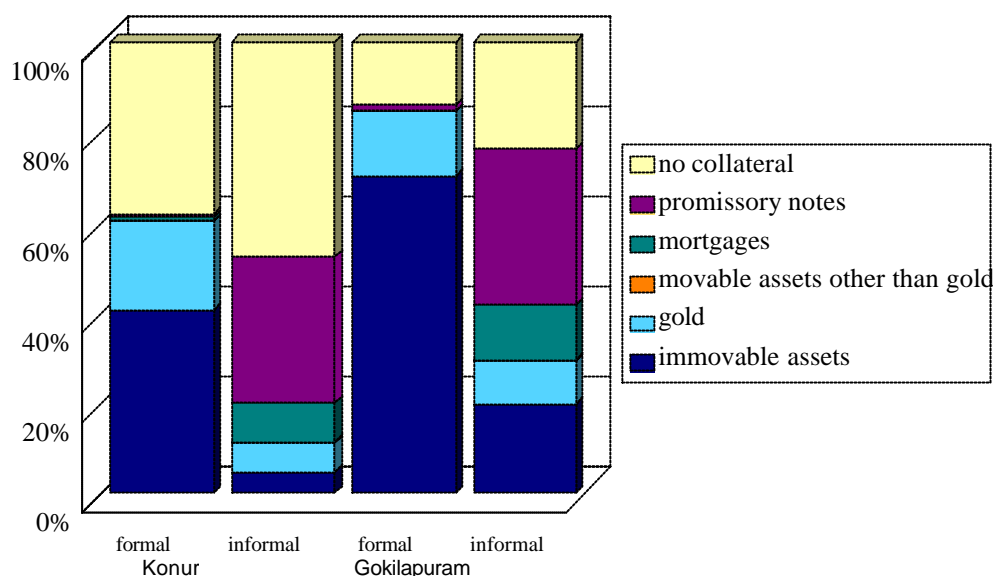
A diametrically opposite view is to say that collateral should only be used to offset some weakness evident in the other four "C's". This view tends to place more emphasis on character and cash flow analysis, and sees collateral as a means of recouping losses only if all else fails. The fixation on collateral shifts the attention of banks from what they really are supposed to do, namely appraise a borrower's character, a project's capacity to produce a net return to service principal and interest, amount of equity capital and business conditions. The preoccupation with collateral leads thus to a suboptimal allocation of funds. While there may be a grain of plausibility to this argument, it is a fact that banks are obliged to protect the assets of their depositors, creditors, owners, which does not leave much room for experiments with unsecured portfolios.

Collateral-free practices are generally associated with the informal financial sector, in fact the absence of collateral is considered to be one of the outstanding features of the informal financial sector⁶ (Timberg/Aiyar, p. 49). This is plausible because of the greater proximity between lender and borrower and the facilities to obtain reliable information on default risk quickly and cheaply. The absence of collateral could also partly explain the high interest rates on informal sector loans which may contain an important risk premium (Christen, p. 20; Ghate, p. 5; Rahman, p. 153). On the other hand, not all informal financial contracts are collateral-free and not all formal financial contracts are collateralized: a survey of 248 households in two villages in Tamil Nadu in 1985 found that between 14% and 38% of formal credit contracts were issued without any collateral; it was also observed that in informal loan contracts a wider range of assets was used for collateral (gold, jewellery, household goods, labour, etc.) (Swaminathan, pp. 165-166).

GDP.

⁶ Reflected in the title of Frits Bouman's book: *Small, short and unsecured - Informal rural finance in India*, Oxford University Press 1989; inversely Swaminathan identifies as one of the two constituent features of formality the type of collateral accepted.

Collateralisation in formal and informal contracts: evidence
from two villages in Tamil Nadu



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The empirical evidence is mixed: several studies find indeed a strong predominance of collateral-free practices (Schrieder/Cuevas on ROSCAs in Cameroon, p. 52; N. Fernando on informal financial market in PNG, p. 122; and A. Bottomley on moneylenders in Ecuador, India and Nigeria, p. 247); others, like Sanderative on Sri Lankan moneylenders and Bouman/Moll on Indonesian moneylenders in urban areas (pp. 93 and 217 respectively), observed that informal loan contracts were indeed secured, even formally, through a promissory note, post-dated checks, chattel mortgage (Timberg/Aiyar, pp. 53-54). In other instances, borrowers "in the informal markets provide . . . real guarantees for their loans (physical collateral) often up to 200% of the amount borrowed" (Bailey, p. 3).

Without going here into the determining factors of collateralization in informal finance (whether the moneylender is a specialized full-time professional or not, where the client is located, how large the loan is, etc.), it is obvious that the available evidence is not compelling with regard to the importance of collateral as a constraint in the informal financial sector, and that informal finance is therefore only of limited value to guide and inspire collateralization by banks.

2. Collateral, collateral law and collateral substitutes

2.1 Collateral

Collateral is an asset pledged by a borrower to a lender until a loan is paid back. If the borrower defaults, then the lender has the right to seize the collateral and sell it to pay off the loan.

A closer look at this standard definition reveals why collateralization tends to pose access problems for small and new borrowers, why collateral is intrinsically linked to the legal system:

– *An asset*

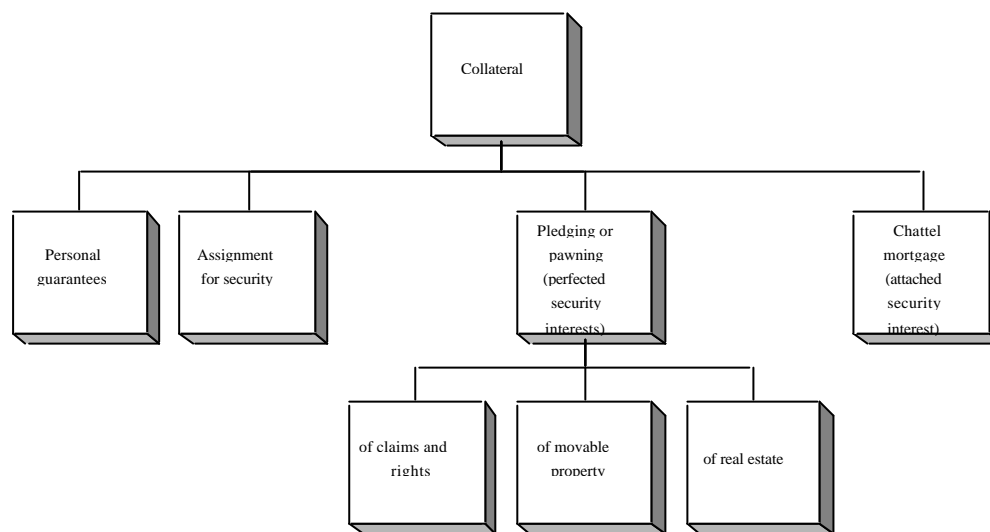
There has to be an asset, a marketable property, start-up businesses or rapidly growing businesses may not have such assets, or at least not of sufficient market value; also there has to be a market for seized assets, whether narrowly defined as physical assets (Binswanger), or more broadly to include also financial assets and even off-balance sheet assets like personal guarantees. "Asset" also implies a certain specificity; after all, the loan against which the asset is pledged is also defined. Borrower and lender must be perfectly clear about what they mean by the asset pledged: contract law usually provides guidance in this respect, at least in the formal financial sector. In the informal financial sector, it is customary law and unwritten social norms. The specification of assets may be fairly straightforward with most forms of real and financial assets, but some moveable properties escape a precise definition in quantity and quality: stored merchandise, perishable goods; in these cases, it is not the asset as such that becomes the object of the pledge, but the storage room with its contents (Büschgen, p. 719; Fleisig, 1994, p. 9).

– *A pledge*

Secondly, there has to be a pledge by the borrower to the lender, i.e. a more or less formal, contractual obligation in exchange of an advance of money. Again, the norms governing the validity of a pledge are either formally legal (in the formal financial sector) or informally binding; differences of views about who has pledged what asset to whom are obviously inextricably interwoven with norms surrounding individual contracts. The complications get worse if an asset is not physically transferred into a lender's possession, but remains at the borrower's disposal, so that the question of property, ownership and appropriability can effectively only be resolved by recourse to the law. This pledge can imply the physical transfer of an asset into the possession by the lender where that is possible (i.e. moveable assets), but more often the pledge concerns only the appropriability of an asset by the lender, not its effective possession (chattel mortgage in contrast to pledging). The borrower also retains the right to the returns accruing from the use of the asset pledged (land, machines and tools).

While all forms of collateral have in common the focus on a marketable asset and a link between a money transfer and a conditional cession of some asset, there are distinctions between them with regard to the object pledged as an asset (for example personal vs. real) and to the possession of the asset pledged (attached vs. perfected security interests), as the diagram below shows:

Conventional collateral instruments



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The difference between a large-scale and a small-scale borrower is that the small borrower will only have a very limited range of assets to offer, while the large-scale borrower is more likely to dispose of a full range of assets, and probably also more easily disposed to let some assets go into the possession by a lender.

2.2 The functions of collateral

2.2.1 From the lender's point of view

The lender has the right to demand collateral: basically, collateral serves the lenders' interests.

- *Protection against risk*

Collateral must limit a lender's losses (Besley, p. 4) by giving the lender a protection against the partial or total loss of resources (in addition to the intrinsic capacity of the financed activity to generate a surplus).

- *Screening*

Collateral is also a screening device (next to a number of other screening devices built into a loan contract, for example the interest rate). The pledge in a collateral arrangement means that the borrower could lose part of his property if he does not pay back; the borrower has an interest in paying back. The hesitation of a borrower to provide collateral could signal to the bank that the borrower is fully aware of the implications of making this pledge, and if he does provide collateral, then he is likely to do everything to avoid the loss of the pledged asset.⁷

In addition to these primary functions, collateral also serves to put the lender into a privileged position vis-à-vis other creditors, should the borrower become insolvent; to obtain this effect, the lender must effectively acquire information on prior claims to the same asset. Another, less frequently observed motive for taking collateral is to reduce transaction costs; this is the case with high-quality collateral, for example financial papers held by the bank, the value of which is stable for the duration of the loan and easier to establish than the inherent creditworthiness (Büschgen, p. 716).⁸ By taking collateral, the bank can "save" the transaction costs of having to review a loan application.

While all forms of collateral are expected to perform these functions, lenders prefer some forms of collateral more than others and these preferences vary from country to country, from bank to bank and over time. Even within one and the same bank, the preference for, say, real estate may give place to another form of collateral, sometimes as a result of changed procedural dispositions in the execution of mortgages. Basically, one can distinguish the following criteria:

- marketability;
- appropriability and access to the asset in comparison to other lenders (World Bank, 1994, p. 16);
- transaction costs involved in verifying ownership of assets, valuating them, enforcing security interests, etc.

According to a survey of Austrian banks involved in SME lending, life insurances, financial assets, mortgages and personal guarantees were considered preferable, while chattel mortgage, pawned moveable personal assets and assignment of claims against third parties were less preferred because of costs, limited marketability and appropriability (Schmoll, p. 179). Especially with regard to the transaction cost criterium, it is plausible that loan size determines whether and what form of

⁷ It has been argued that the maximization of collateral conditions does not necessarily yield optimal results; to the contrary, there may be an adverse selection problem, similar to the optimum interest rate to differentiate good from bad borrowers. In other words: is a borrower the more trustworthy, the more collateral he can mobilize? (Stiglitz/Weiss, 1995, p. 695). To some extent lenders can hedge against this by using the interplay/trade-off between price mechanisms (i.e. the interest rate charged on a loan) and non-price mechanisms (such as the use of collateral).

⁸ This clashes somewhat with the banking orthodoxy according to which collateral is only the "second defence line".

collateral is taken: it makes little sense to demand a mortgage for a US\$5,000 loan. With increasing loan size, collateralized lending becomes more widespread, but also costlier in absolute terms, illustrated in a review of Indonesian microfinance institution (Pearson/Garland, p. 7):

Loan size and collateral

Loan size (Rp ,000)	Collateral
10 - 100	No
101 - 500	No, but seek local character reference
501 - 2,000	Inquire about asset ownership
2,001 - 10,000	Ask to see and sometimes hold documentation providing asset ownership
10,001 - 25,000	Secure and hold asset ownership documentation
25,001 +	Legally attach to secured financial and fixed assets, and register a pledge of assets from the client

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2.2.2 *From the borrower's point of view*

For the borrower, on the other hand, while collateral requirements are a constraint, not all forms of collateral are equally constraining: chattel mortgage is a matter of a certified transfer of the document testifying ownership to a machine; land titles and mortgages are more time-consuming to establish. Personal guarantees may be fairly easy to obtain, but whether they are accepted by the bank is another matter; there is always the reciprocal obligation in a personal guarantee, which may not always be pleasant. Tools and equipment can be easily pledged under a chattel mortgage, but if they are seized, then business activities could be severely disrupted. Some of the most obvious borrower criteria of preferability of different types of collateral are:

- transaction costs;
- impact on current household and enterprise affairs;
- social exposure.

However, in real life and especially in the real life of small businesses, it often occurs that:

- the borrower simply does not dispose of enough assets to satisfy the borrower's securization needs; or
- the pledged asset is not easily or no longer marketable, nor to an extent to cover the loan amount fully, with interest and collection cost (Esguerra/Meyer, p. 2); or
- the lender may feel that costs of liquidating the collateral may justify some extra protection.

In these instances, the loan contract could still be concluded with the help of a "substitute".

2.3 Collateral substitute

"Collateral substitute" is an evasive notion. Sometimes, it is simply meant to describe a form of securing a loan that is to cover a shortfall in "solid" collateral: for example, in the case of the borrower who wishes to contract a US\$100,000 loan but disposes only of real assets assessed at US\$80,000; the bank in question – for whatever reasons – would prefer real assets but is prepared to accept exceptionally also, say, a personal guarantee from a third party; in this view the personal guarantee is a substitute.

Sometimes substitution is more strictly interpreted to describe cases of a complete replacement of preferred forms of collateral by less preferred, but still accepted forms: in the above example, the substitute would be a US\$100,000 personal guarantee or life insurance, etc.

Sometimes, substitution is a term used to describe a situation where a bank accepts an unusual form of a guarantee although the loan is already fully covered by conventional means: in our example, this would occur once the bank takes household goods assessed at US\$20,000 on top of a US\$100,000 mortgage for a US\$100,000 loan.

The different meanings attached to "collateral substitutes" and "substitution" emphasize either a pledged asset's:

- unusual occurrence, innovative nature or
- its para-legal character of enforcement or
- its limited marketability.⁹

⁹ Confusingly, the literature labels "collateral substitutes" items that have a market value and that can be repossessed, like inventories, savings deposits, accounts receivable, co-maker arrangements, guarantee fund commitments (see, for example, Najarajan/Meyer, p. 2). Sometimes, joint liability is presented as a particular form of a personal guarantee and interlinked contracts as a specific application of assignment of income and blocked savings as a form of assignment for security (Hartig, pp. 191-202), although their enforceability through courts is doubtful.

Is leasing a collateral substitute?

Leasing is a form of debt financing, but in contrast to loan contracts, leasing does not require collateral. The lease-giver retains full ownership of the machinery; there are no costs involved in verifying property rights of the lease-taker and if the lease-taker is negligent in lease payments, enforcement and repossession are automatic and do not require court action.

Moreover, there is a lively market for leased equipment, including among specialized leasing companies.

Purely in terms of facilities to get around a collateral constraint and disregarding other aspects (impact on the cash flow of the lease-taker, fiscal drawbacks) a leasing contract would seem to be an attractive alternative to a loan contract. (Point made by van Rijn, Steel, SDC.)

Enforceability of loan contracts and marketability of seized assets signal the borderline of the formal financial sector; if a major objective in financial sector development is to push out further the sector's frontiers so as to broaden the access of the poor to the market, then it is interesting to explore ways to enforce creditor claims that do not involve the formal judicial process. In most developing countries, the law and its administration do not reach the poor; and even if they did, then the poor would not be able to afford legal recourse. Any effective extra-legal mechanism is therefore relevant for financial sector broadening.

The same applies to marketability; while the majority of the population has no or very limited real and financial assets that can be pledged as collateral, they do have some personal or family belongings to which they are attached; if such "assets" perform comparable risk protection and screening functions and are accepted by a bank, then this could have far-reaching implications for financial sector broadening.

In contrast to a "collateral", a "substitute" is characterized by two criteria:

1. it is not enforceable through courts (or even if it is, it will not be enforced through courts in which case the threat of enforcing a claim – by whatever para-legal or social means – is the security interest (e.g. Grameen Bank));
2. it has no or little market value (example: household goods, promissory notes signed by the borrower).

2.4 Collateral law

There is no collateral law in the sense that it constitutes a coherent body of dispositions,¹⁰ collateral law is rather a collection of dispositions in different legal compartments in private law and in penal law:

Private law

- contract law (especially the general dispositions of the Code of Obligations of some countries governing standard form contracts used by major banking groups)¹¹
- property law (especially the dispositions of security rights over movables)
- commercial law (especially concerning registers with information on ownership of company assets)
- judicial process law
- general code of civil procedure
- bankruptcy code (prior claims to pledged assets)
- special laws concerning foreclosure (judicial execution), sale by court order and sequestration
- decrees governing land registers and other registers

Penal law

- usury prohibition (which does not explicitly deal with collateral, but indirectly limits the scope to compensate for insufficient collateral by charging higher interest rates).

The various dispositions affect how the parties of a loan contract go about the:

- selection of assets for collateral ("creating security interests");
- verification of ownership ("perfecting security interests");
- realization of pledged assets/titles through foreclosure and other means ("enforcing security interests" (Fleisig)).

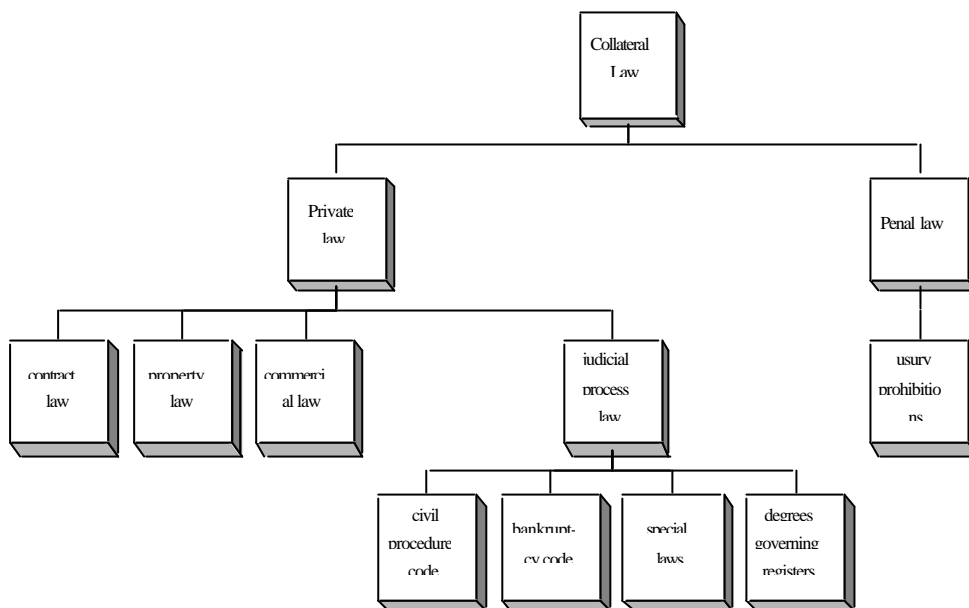
¹⁰ This does not preclude the possibility to modify the dispositions in disparate legal fields simultaneously and in a coherent fashion so as to produce something close to a "collateral law" (illustrated in USAID's project title "Collateral Law Reform Project" in Bulgaria).

¹¹ The standard form contracts (AGB), the small print of loan contracts, govern rights and obligations between a bank and a borrower. The borrower submits to these conditions upon signing the loan contract. The 3 major banking groups in Germany, for example, have their own set of standard form contracts, and the securization of bank claims against the client figure prominently: right of the bank to demand collateral; extent and limitation of security interest; exceptions; right of the bank to choose between forms of collateral in execution; conditions for realization and execution; right to claim supplementary collateral because of changes in risk; obligation of the bank to release collateral if its value exceeds not just temporarily the value of all claims; etc. etc.

Generally, from the point of view of internal rules, cooperative banks do not treat their customers differently than commercial banks with regard to securization of loans, while the stipulations of savings banks are less extensive and in some respects even more customer-friendly (for example, the rules governing the release of part of security).

Collateral law:

dispositions in different legal compartments



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The rules governing the "creation of security interest", in other words the specification of the asset pledged as collateral, differ from one legal system to another. In Uruguay, for example, the law requires that property be in all cases enumerated, which can pose a problem with cattle or merchandise-based contracts (World Bank, 1994 and Fleisig, 1995a, p. 2). Other legal systems allow for floating pledges where the generic contents of a specific warehouse are pledged (Büschgen, p. 719).

Once an asset is specified the lender wants to know whether the borrower is really the owner of the asset. This is a question of documenting property rights reflected, for example, in land registers. The verification of ownership titles can pose problems if registers are outdated, incomplete, inaccessible, not transparent, costly to consult. Fleisig quotes the cases of Bolivia and Uruguay where it is "extremely difficult to search the records for prior claims against collateral" (1995a, p. 2). In fact, USAID's Collateral Law Reform project in Eastern Europe has singled out as one of its three objectives the need to develop registries that help "determine whether another lender has a prior claim to the collateral".

The law of judicial process becomes relevant after a loan contract has been concluded and collateralized and once the borrower's non-repayment gives rise to the lender's decision to seize collateral. The law of judicial process determines the terms and conditions of enforceability of claims based on collateral by way of:¹²

¹² It is one of the intriguing features of commercial banks to insist on land titles, although they are fully aware of limitations to the social and practical enforceability of claims based on such titles.

- lengthy (and hence costly) judicial procedures;
- requirements limiting or excluding direct action by the lender against the borrower (court orders);
- a limitation in the access to accelerated court orders;
- exemptions of parts of property from repossession (homestead clauses).

In contrast to these extensive civil law dispositions, the public law is rather mute on collateral as a specific issue. Germany's law governing credit activities of banks, for example, does not refer to the securization of loan transactions at all. Neither the principle nor the forms of collateral are explicitly prescribed. Neither the Federal Office for Banking Supervision nor the Bundesbank set limits to or allow exceptions for the extent and nature of collateralization, whether in individual loan transactions or in the entire loan portfolio of banks. It is the responsibility of primary banks to look after the security of their portfolios.

However, to the extent that Central Banks oblige banks to differentiate between assets secured by different degrees of repossession and registration facilities and declare as high-risk those loans secured by collateral substitutes, Central Banks regulations indirectly affect collateral-taking as well, because banks would be compelled to increase their capital base to meet the minimum capital adequacy requirements of the Basel Accords (V. White, USAID).

Collateral and the German Law on banks and financial institutions (KWG)

The Swiss Banking Law (8.11.1934) stipulates in article 4 that a bank's exposure in terms of loans and advances has to be in proportion to its equity. This is further detailed in the Banking Decree of 1972. Article 12 defines which assets have to be weighted by what % age to allow the calculation of the equity requirement (of 8%). This classification gives an implicit ranking of different forms of collateral: for example, the borrower's financial assets held by the same bank are not at all discounted for risk, in other words they represent the most preferable form of guarantee (12a, 1.4-1.5); while options and futures are discounted at 25% for the purposes of calculation of equity requirement, mortgages at 50%, receivables from banks outside of OECD countries at 100%, etc. While this grading/ranking reflects the supervisory organs' (Bank Commission) perception of the ease of execution, enforcement and liquidation of different forms of assets, it does not have a normative, binding effect on the way banks take particular types of collateral or exclude the use of other types.

Collateral and the Swiss Banking Law

Paragraph 18 of the KWG stipulates that under certain conditions banks may be entitled to forego the presentation of detailed and complete financial statements from their potential clients, namely when and if it would be unfounded to do so in view of the quality of collateral provided. The decree of application explains further that certain forms of collateral can generally be considered for this possibility, namely: mortgage papers, financial assets (shares, bonds, participations, sight and term deposits, life insurances): however, always with a certain discount varying between 25 and 40% of the nominal value of the assets. Other forms of collateral can also be considered for this exemption provided their realization covers principal and interest "under all imaginable circumstances". Chattel mortgage and assignment for security, however, can only in exceptional cases be considered a valid justification for not requiring financial statements.

3. Collateral law and collateral substitution: Limitations and scope from the point of view of small borrowers

3.1 Does collateral law work?

A "good" collateral law should:

- encourage the conclusion of many financial contracts (density);
- broaden the financial sector by making it more accessible (access);
- and at the same time maintain or even raise the general level of financial contract security reflected in a fairly low default rate and limited default losses across the financial sector (quality).

Collateral law can contribute to financial sector broadening by allowing for substitution arrangements to the benefit of borrowers with solid investment proposals but without assets (basically the situation of first-time borrowers); collateral law can secondly enhance the densification of loan contracts by minimizing the transaction costs involved for borrowers and lenders in creating, perfecting and enforcing security interests (basically the situation of borrowers with a certain loan record but still undercollateralized, i.e. small and medium-sized enterprises).

3.1.1 Does collateral law influence substitution?

The banks and financial NGOs in Malaysia, Indonesia and the Philippines interviewed in the framework of an ILO/APRACA survey declared that they did not consider themselves really constrained by legal or regulatory dispositions in experiments with collateral innovations. Institutions in Indonesia, however, added that they felt encouraged by the Financial Sector Reform in the late 1980s (see box on Bank Indonesia/GTZ) which allowed them some flexibility in dealing with NGOs as subcontractors or wholesale agents. The sort of encouragement that they would like to get from public authorities was in terms of guarantee funds and other risk-sharing arrangements, i.e. had little to do with the law.

Linking banks and self-help groups in Indonesia

The Project Linking Banks and Self-Help Groups (PHBK) aims to improve the availability of financial services in rural areas by promoting and supporting linkages between banks and self-help groups (SHG). The project is being implemented by Bank Indonesia with German technical assistance since 1988.

Indonesian Bank Regulations (UU7/1992) require banks to assess borrower creditworthiness, independently of the kind of collateral offered. Collateral substitution within the framework of this project and in Indonesia generally, has benefited from the legal and regulatory environment: for example, since 1992, projects with credit secured by collateral substitutes have received the same valuation by Central Bank authorities as those with traditional securities. Also the norms for the registration of financial self-help groups, the legal procedures for the registration of SHGs, and the establishment of rural banks (BPR) in villages have been simplified.

Backed by the new Indonesian banking law, PHBK supplements traditional physical collateral with alternative collateral like joint liability and peer pressure.

The key lesson is that collateral substitutes can be highly successful in a linkage approach - provided the legal and regulatory environment incentive-oriented.

Source: GTZ

3.1.2 Does collateral law exacerbate credit rationing?

High transaction costs in connection with specifying, validating and realizing collateral may ration out smaller- and medium-sized borrowers. This is not at all unlikely, considering the way the law in many countries is administered. Often the institutions for the enforcement of claims do not exist (bailiff, courts) or, if they exist, they function too slowly. Rational lenders will require only collateral that can be liquidated without court orders, i.e. financial assets in the possession of the lender. This could have a rationing effect on small businesses to the extent that they do not have financial assets to pledge (except savings deposits).

In most countries, the legal execution of claims into moveable property requires the intervention of a bailiff; the bank as creditor has to have already a writ of execution (for example a court judgement) or a title deed (i.e. a document with an immediate executory effect, signed and recognized by the debtors) in order to obtain satisfaction by the bailiff. Again, to the extent that smaller clients do not have such titles, one could say that the law reinforces an existing rationing-out effect.

Furthermore, not all moveable property can be seized: paragraph 811 of the German Code of Civil Procedure, for example, explicitly exempts from seizure tools, equipment and stocks of raw

materials essential for the continued operation of the debtors, in other words the assets that the banks may have helped to finance and to which a lien may have been established. This will make banks think twice about taking chattel mortgage in small enterprises, particularly if the courts tend to interpret the homestead clause fairly broadly.

Not all receivables can be seized by virtue of a court order: claims against pension funds, reimbursements of staff for costs incurred, paid annual leave of employees, untransferable claims are exempted. These restrictions are not necessarily known to the bank. This could have a discriminating effect on those borrowers that have primarily moveable intangible assets to pledge (receivables, financial papers).

The legal execution into mortgaged property can be in the form of a bankruptcy sale or sequestration (i.e. the administration of a house or a piece of land by the creditor allowing the extraction of revenue out of the continued use of the asset). Both forms presuppose that the debtor is clearly indicated in the land register and that the register is complete and up-to-date with regard to prior claims to the same asset: again, the inefficient administration of registers may penalize smaller businesses, because banks may refuse to proceed with verification while a larger-scale client may get more attention if endowed with other, non-registered assets.

To sum up, the legal framework could conceivably hamper financial transactions when lenders want to ascertain property rights and enforce claims, but are discouraged from concluding the contract because of exorbitant, collateral-related transaction costs. There may be gains in modernizing registers and simplifying enforcement procedures in situations where lenders, and especially banks, would consider verifying the ownership of assets, provided the transaction costs can be brought down to a level compatible with the size of the envisaged transaction.

However, not much is known empirically about the actual transaction costs related to collateralization, neither in the formal nor the informal financial sector. Also, unexplored are the relative effects on financial contracts of measures like introducing new laws (shortened stays in court) or more efficient law administration (for example computerized registers).

3.2 How do collateral substitutes perform?

Genuine collateral substitutes (i.e. not marketable assets and para-legal or social enforcement) are, for example:¹³

- peer pressure (group-based forms of collateral like joint liability);

- probation or credit-scoring (i.e. the threat of loss of access to future loans);
- interlinked contracts;
- co-maker arrangement without intended enforcement.

Since the primary function of collateral is to screen out and to protect against default risks, then the repayment rate would be the first performance indicator of a collateral substitute. However, repayment in isolation is not a meaningful indicator: clearly, lenders want to maximize repayment of appraisal, monitoring and collection effort, all of which entail transaction costs. It makes sense to take costs as a second criterion for measuring the performance of collateral substitutes, i.e. the transaction costs for borrower and lender in selecting an asset, in using it and in realizing it, if necessary, in case of default. Since the interest is to explore the conditions for bank-institutional learning with regard to credit technologies, it seems plausible to take as third performance criterion the extent to which collateral substitution has become a bank-internal habit, i.e. the extent to which it has been mainstreamed, within a bank and perhaps even across the financial sector.

3.2.1 *How widely are collateral substitutes being used?*

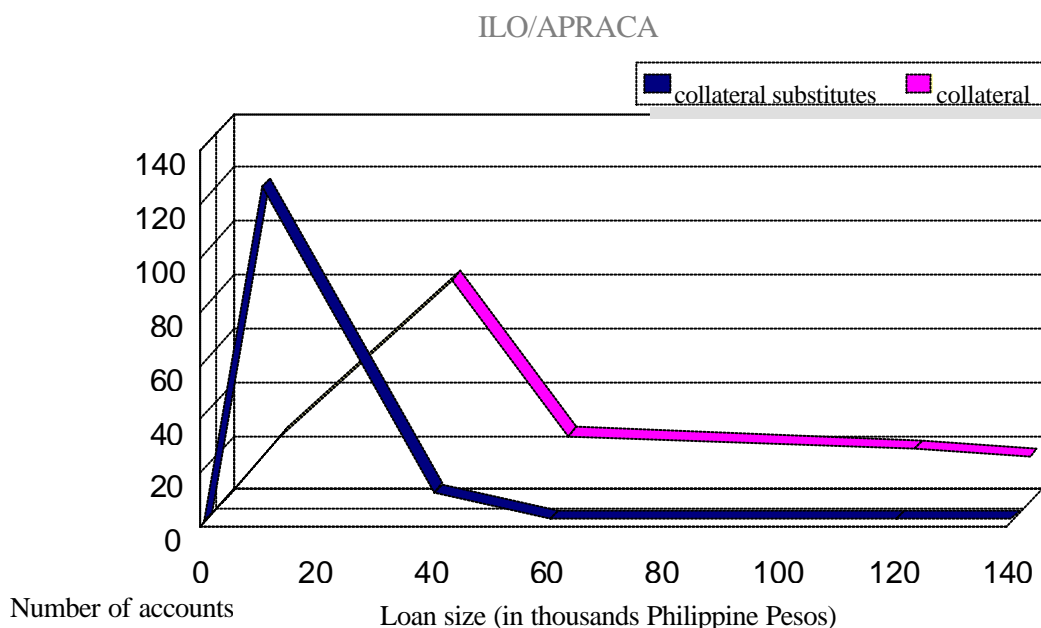
Before looking at the performance of collateral substitutes, it may be useful to recall a few facts that show that this is not a marginal or ephemeral phenomenon. In 1994/95, an ILO/APRACA/SDC survey reviewed several hundred sample accounts in several banks and financial NGOs in Indonesia, Malaysia and the Philippines to determine the extent of the use of collateral substitutes and its effects. The types of collateral substitutes examined were: joint liability, co-making arrangements and cession of professional licences or car papers. The institutions/organizations participating in this exercise were primarily government-owned rural banks (BPM in Malaysia, LANDBANK in the Philippines), cooperatively-organized rural banks (CRB Laguna in the Philippines), private for profit rural banks (CR Calamba in the Philippines, BPR Shinta Daya in Indonesia) and financial NGOs (TSPI in the Philippines and BINA SWADAYA and BPR Jatiarta in Indonesia), all of which target credit at "small borrowers", defined in terms of loan size, asset value, occupation, gender or a combination of these criteria.

With the exception of the Philippine TSPI programme, collateral substitutes are rarely used in isolation, but always in combination with traditional collateral (or with what is considered to be a substitute, but is in actual fact a traditional collateral, i.e. blocked group or individual savings). Collateral substitutes are being used both within special schemes and in "mainstream" operations; it is not clear whether the use of collateral substitutes in mainstream operations is the result of

¹³ In the real world, these forms are often intertwined: the group exerts pressure on the defaulting member precisely because the sanction is to be cut off from a future supply of credit, not because the bank executes and repossesses into other group members.

experiences made in special schemes. The institutions put partly own resources at risk. The survey found consistently a strong correlation between loan size and use of collateral: the larger the loan, the more likely a traditional collateral requirement (Haryadi and Ramli, p. 18; Casuga/Hernandez, p. 26). Assuming that new entrants to the financial market are more likely to demand comparatively smaller loan amounts, then this correlation could signal that collateral substitution provides a bridge for first-time, small-scale borrowers.

Collateralisation related to loan size



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Group guarantees based on peer monitoring are the collateral substitute most widely used, particularly in several Asian countries. Evidence from Thailand and India shows that the majority of titled farmers have provided land as collateral while untitled farmers offered group guarantees to obtain bank loans (Huppi/Feder). Thailand's Bank for Agriculture and Agricultural Cooperatives (BAAC) is well known for its extensive use of joint liability groups. "In 1984-85 a total of 628,194 clients made 773,233 loan contracts based on joint liability security. These clients represent 13% of all farmers in Thailand, 48% of all farmers registered as direct clients of the bank and 80% of all the direct clients who borrowed during that year. . . ; joint liability loans disbursed were US\$280 million, i.e. 44% of all BAAC's disbursements" (Tohtong, p. 5). Grameen Bank's "general loans" are entirely secured by joint liability groups (Khandker, pp. 8 and 22): they made up 81.6% of its total portfolio in 1992.

Outside of these well-known examples, collateral substitution is also pervasive in the informal and semi-formal financial institutions: the review of sources of credit for the rural poor in the Gambia (Zeller et al., pp. 176-177) found evidence of collateral substitution (social pressure) in credit unions, NGOs and the informal financial sector, interlinked contracts in credit unions, while

commercial banks accepted only real estate titles. The USAID/AITEC supported ACCION affiliates are also entirely built on the solidarity group concept: "no one in the group can have access to a new loan until the whole group has repaid the previous one" (Otero, p. 6).¹⁴ USAID's analysis of 11 of its own microfinance programs suggests that experiments with collateral, including its genuine substitution, are typical of a successful micro-finance lending methodology, be it complete substitution with peer pressure as in the solidarity group and village banking approaches or partial substitution as in the individual lending approach (Christen/Rhyne/Vogel, p. 17).

Caja de Ahorro y Prestamo Los Andes S.A.: Concept to solve the collateral security problem in the urban informal sector in Bolivia

Urban micro-enterprises in Bolivia are practically excluded from access to credit in the formal financial sector because of the lack of conventional collateral and inadequate legal remedies. Since 1991, the Caja de Ahorro y Prestamo Los Andes (until 1995: NGO Procredito) has been implementing, supported by German bilateral technical assistance, a credit technology adapted to the situation of small-scale enterprises in the informal sector to solve the collateral problem. The Caja has been administering a credit volume, at the end of 1995, of some US\$6 million, consisting of about 16,000 single credits. With an average loan amount of less than US\$500, the Caja is serving mostly the poorer groups of micro-enterprises.

In contrast to the traditional collateral usually requested by commercial banks, such as mortgages, the demand for collateral under this programme is limited to anything of value that can easily be given by the borrower. Assets of the enterprise to be financed (including working capital and merchandise) and household goods (e.g. TV, HiFi, sewing machines, jewels) are accepted as collateral. Of crucial importance is that these goods have a certain (replacement) value for the customer, be it material or even non-material, and that the threat of repossession is serious should the borrower fail to repay the loan. It is of secondary importance whether in case of default all claims by the creditor are fully secured.

The sanction mechanism is occasionally also combined with a probation approach: initially, relatively small loans are provided below the customer's borrowing ability. If the willingness to repay has been demonstrated by means of timely repayments the borrower can be given access to more substantial credits. At the end of 1995, the share of credit repayments outstanding for more than 30 days amounted to only 0.5% of the portfolio. Every credit analyst handles a portfolio of 266 clients; the administrative cost represent 23.9% of the credit volume. The Caja has been operating on a cost-recovery basis since 1994.

Source: GTZ

¹⁴ In both cases, however, the notion of joint liability does not mean that the bank would actually threaten to execute into any group member's moveable or unmoveable property, whether he is the defaulting member or not; the sanction is rather the prospect of no longer having access to credit. This diluted form of joint liability is actually a mix of social pressure and probation.

3.2.2 *Peer pressure*

3.2.2.1 *In terms of repayment*¹⁵

The ILO/APRACA/SDC survey found that, in terms of collection and past due ratios, collateral substitutes produce equivalent (and in the case of the BPM in Malaysia, even superior) results compared to collateralized loans. A review of 15 group lending schemes applying the peer pressure technique (Huppi/Feder) found that the repayment enforcement mechanism was effective; it worked particularly well if the lender is perceived to be able to provide such services over a longer period of time. Other factors of success were: small group-size, homogeneous, self-selecting groups, common bonds, mandatory savings, regular repayment schedules with fairly small investments. The main finding is that while "experience does not clearly indicate whether lending to individuals or lending to groups as a whole yields better results, . . . practice has shown that joint liability has positive effects on repayments if certain conditions are met" (Huppi/Feder, p. 22).

Joint liability loans represent the largest share in the entire portfolio of Thailand's BAAC from 1987 onwards, reaching in 1993 a level of close to US\$1 million in loans outstanding. The repayment rate increased from 77% in 1987 to 90% in 1992 and was generally superior to the repayment performance of all other BAAC loan types (cooperatives, mortgage, special projects), except paddy pledging (BAAC, p. 15).

In 18 ACCION affiliates operating with the solidarity group principle, "the average level of arrearage was about 12%" (M. Otero, p. 12), with a range from 0% to 26%. Grameen Bank reported recovery rates of 95% in 1991 (Khandker, p. 23).¹⁶ The Grameen Trust reports for 29 Grameen Replication projects repayment rates between 59% (ASKI, Philippines) and 100% as of November 1995. In 8 minimalist NGO programmes in Kenya, also employing the joint liability model, the repayment rate varied between 78% and 100% (Kesterton, p. 17).

BRI Unit Desa and BKK are two well-known micro-finance institutions in Indonesia. Both operate in rural areas of Central Java, the former catering to better off clients who can pledge land

¹⁵ Strictly significant would only be a comparison between a batch of loan portfolio that is conventionally secured and another part that is secured with a collateral substitute. However, with a few exceptions, this intra-bank comparison is not documented; and even if such data were available, the usual multi-variate limitations would apply.

¹⁶ Yaron (Successful Rural Finance Institutions, 1991) points out that Grameen Bank uses a fairly broad-minded definition of arrears, namely one year past due, which makes the recovery rate look better. According to a KfW evaluation of 1994, Grameen Bank treats as "arrears" those amounts that are not repaid after even two years past due! (point made by W. Neuhauss, KfW).

and comparable assets, while the latter's loans are unsecured. In terms of long-term loss ratio, they compare as follows (December 1987): BRI Unit Desa: 1.35%; BKKs: 1.98% (Patten/Rosengard, p. 96). More recently (1990, Yaron, Successful RFIs, p. 30) BRI Unit Desa and BKK had annual loan collection rates of 95% and 80% respectively. From 1992 to 1994, BRI's Division of Village Units registered past due ratios of 9.1%, 6.4% and 4.4% respectively (Indonesia report of ILO/APRACA project, p. XX).

Eleven micro-finance programmes, using the solidarity group approach or the individual lending technique compare in terms of loan delinquency rates (defined as outstanding balances of loans with payments late over 90 days) as follows (Christen/Rhyne/ Vogel):

Loan delinquency rates of solidarity group approach and individual lending technique

Joint liability		Individual lending without collateral	
Grameen	0.0%	BKD (Indonesia)	10.3%
K-REP	0.0%	LPD (Indonesia)	3.9%
ADOPEM	4.0%	BRD (Indonesia)	20.0%
FINCA	1.7%	BRI	6.5%
CORPOSOL	1.3%	ACEP	3.0%
BANKOSOL	0.0%		

Source: Christen/Rhyne/Vogel

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The Small Farmer Development Programme (SFDP) and the Production Credit for Rural Women (PCRW), both in Nepal, are also using almost exclusively joint liability as a credit delivery technique, but much less successfully. Here the repayment performance is less impressive: SFDP reported 33% of "estimated bad debt losses of principal incurred on each year's disbursement" (Bennett, p. 16), while PCRW failed even to disclose its performance.

More recently, the longer-term solidity of peer monitoring as a screening and sanctioning mechanism has been put into question. Over time, successful joint liability schemes appear to lead inevitably to internal power rifts, thus eroding internal social control while attracting alternative sources of credit supply in the local financial market, thus undermining the effectiveness of scarcity as an incentive (Yaquib, p. 10).

3.2.2.2 *In terms of transaction cost*

Transaction costs matter in the entire loan cycle, but in particular with regard to collateralization, this applies to both lender and borrower transaction costs. A review of the administrative costs incurred by different types of financial institutions in the Philippines showed that lender costs related to loan recovery amount to about half of total lending costs (including advertising, promotion, planning, loan processing, monitoring) (Llanto/Chua), independent of the type of supplier (commercial banks, rural banks, cooperative rural banks, multipurpose cooperatives). This suggests that the selection of the collateral instrument has considerable cost implications for the lender, particularly with regard to enforcement and recovery. Even in the informal financial sector, "screening and enforcement costs are about 14% of marginal costs of lending operations" (Hoff/Stiglitz, p. 244). The question is, therefore, at what cost good repayment performance?

Some collateral substitutes, like "joint liability", come with cost advantages, namely by reducing lender transaction costs through externalization to a group of prospective borrowers.¹⁷ Rather than selecting the credit risk itself, the bank relies on the self-selection mechanism in joint liability groups. Llanto/Chua found that the involvement of NGOs in group formation and training increased transaction costs by approximately 20%. This cost advantage to a bank can be further enhanced when – as in the Grameen Bank – the collateral instrument is actually just the threat of calling on the joint and several liability, but not execution, repossession and seizure into the property of group members, all of which obviously would be fairly cost-intensive.

Of course, joint liability does not eliminate all lender transaction costs (somebody in the bank has to check on the previous repayment performance, the group still has to be notified of arrears and default by correspondence or visits, group-internal differences might require the mediation by the loan officer, etc.), all of which still entail some administrative costs to the bank. Yet, on the whole, a bank is probably better off with a delivery mechanism that externalizes costs (and, even better, risks). The review of group-lending schemes by Huppi/Feder finds evidence of scale economies provided "lenders are not required to carry group formation costs" (p. 25).

Whether borrower transaction costs in joint liability exceed those required by more conventional forms of collateral is an open question. A financial NGO in the Dominican Republic that operated group-based lending and individual lending at the same time observed that "group members lost less total work time and . . . less on travel expenses than individual borrowers. The opportunity cost of time taken . . . amounted to only RD\$75 for the group, while the same costs for the 10 individual loans totalled almost RD\$400." (Adams/Romero, p. 10). This would seem

¹⁷ This is not to be confused with the argument that "group lending" reduces a lender's transaction costs in terms of lower per unit costs (Feder/Huppi, 1989); what is meant here is the comparison between transaction costs involved in establishing conventional security interests and those involved in establishing substitute security interests.

plausible because of "savings in fees for collateral registration, expenses on certificates needed for a loan application and on time and transportation costs of visiting lenders" (Huppi/Feder, p. 26). This would suggest that from a cost perspective, a borrower could be better off with joint liability.

On the other hand, the comparisons of group vs. individual lending should also take into consideration the costs of default of another group member and the longer term opportunity and transaction costs if a member or a group is definitely deprived from the access to credit as a result of default. To become a member of a joint liability group makes sense for a rational microentrepreneur if the return to the investment financed by a loan exceeds the transaction costs involved in getting the loan and if there is no alternative available to obtain the loan at lower cost. The stability of joint liability groups would positively signal such a utility.¹⁸ However, not much reliable data is available to say with certainty whether borrower transaction costs in joint liability schemes are lower or higher than in other collateralization modes (if at all available!).

3.2.2.3 In terms of building up durable bank-client relations and in terms of mainstreaming

If the underlying idea of collateral substitution is to facilitate access to the formal financial sector or at least to a regular flow of credit, then the longevity and institution-internal mainstreaming of such arrangements are also indicators of whether collateral substitution works. The question is whether, based on fairly satisfactory results in terms of repayment and transaction costs, a bank continues to accept a substitute, thus making it over time into a perfectly normal screening, incentive and enforcement device.

Bank Pertanian Malaysia, for example, uses joint liability as a risk protection device over 25 years. Other financial institutions in the Philippines and Indonesia surveyed in the ILO/APRACA project, use joint liability more or less extensively since years:

¹⁸ Notwithstanding the observation made in Thailand where people form joint liability groups although they do not even need credit nor intend to apply for it (Steinwand, p. 43).

Philippines

Land Bank	4 years
Cooperative Rural Bank Laguna	17 years
LBP Batangas	4 years
Rural Bank Calamba	18 years

Indonesia

BPR Shinta Daya	6 years
Bina Swadaya	28 years
BPR Jatiarta	2 years

Grameen Bank, the ACCION affiliates, K-REP, etc. also have been operating with joint liability over a sufficiently long period of time to be evidence of at least limited institution-internal acceptance. It is true, none of the above institutions are "normal" banks: either they are government-owned rural banks, or NGOs transformed into banks or NGOs/self-help organizations/cooperatives with financial functions.

3.2.3 Probation

Peer monitoring works as a screening and risk protection device, provided groups have reasons to be concerned about a future supply of credit and if alternative sources of credit supply on comparable terms and conditions are not available. The "security interest" here is the repayment performance of every group member in the present. Such a security interest based on rational expectations does not necessarily have to be group-based, it can also work in the transaction with an individual borrower. Provided the lender has the capacity to increase loan sizes continuously and in relation to the absorption capacity of the borrower, there are a number of incentives that have a similar screening and risk protection effect as peer pressure. The lender can offer to the borrower prospective incentives in subsequent loan transactions, like:

- continued access to the same flow of financial services;
- a rebate on future interest payments;
- progressively larger loan amounts;
- a more flexible repayment schedule;
- or a combination of the above.

Probation can also be considered as a genuine substitute because the pledge that secures a loan is simply a promise, there is no asset of any commercial value. The borrower does not pledge anything other than his/her good will to pay back the loan in time.¹⁹

¹⁹ Of course, as Hoff/Stiglitz (p. 240) have pointed out, this has only an incentive effect if the borrower can expect to get a surplus out of a debt contract; which in turn requires that the interest rate cannot be too high.

Compared to "peer pressure", in joint liability arrangements there is much less information on how "probation" performs as a device to ensure repayment, what the transactions costs are for lender and borrower and whether it has become a major loan securization technique in any regular bank. Among the few documented micro-finance programme using the probation approach is PROCREDITO in Bolivia (see box on p. 25). Several micro-finance programmes in Indonesia (BKK, P4K, LDKP, BPR Sempoerna) and the Philippines (KMBI, BASIDECO) also operate with probation of individual borrowers, BRI/Kupedes is perhaps the best known example. BRI's policy is to demand collateral whenever this is realistic,²⁰ but otherwise it allocates unsecured individual loans in very small amounts (starting from US\$ 100) that are renewed with progressively larger amounts if the repayment performance in the preceding period was satisfactory. In 1993, BRI registered an overall loan delinquency rate (volume of outstanding balances payments late over 90 days) of 6.5% (Christen/Rhyne/Vogel, p. 3); available data does not allow to segregate the BRI portfolio by type of collateralization to see whether the unsecured portion performed better than the collateralized portion. BKKs and KURKs in Central and East Java also operate with a probation technique based on interest rebates and progressively increasing loan size. In 1992, they reported arrears rates of 2.1% and 9.7% respectively (Mosley, pp. 5-7).

In terms of transaction costs, probation would seem to be fairly attractive for the borrower since collateral transaction costs are limited to direct dealings with the bank: there are no group sessions to attend. For the lender, on the other hand, probation with its short loan cycles involves intensive performance monitoring and hence probably some administrative costs. It would seem plausible that they even exceed the costs incurred by the lender when dealing with joint-liability groups. Why then would a bank like BRI use this collateral substitute? One reason could be that probation lending concerns only a marginal portion of its portfolio which means that losses can be easily cross-subsidized. Another consideration could be that risk exposure of unsecured lending is bound by the small amounts of debt exposed and by the fact that short loan cycles signal underperforming assets fairly early. It would be interesting to explore this further in view of the scope for institutional learning and the increasing popularity of credit scoring for consumer loans in developed financial markets.

3.2.4 Interlinked contracts

Another collateral substitute are interlinked contracts. They are quite common in the informal financial sector of many countries, including in industrialised countries (dei Ottati, pp. 534-543). They are based on the principle that "lenders who are landlords or merchants may use the contractual terms in these other exchanges to affect the probability of default" (Hoff/Stiglitz, p. 240). Interlinked contracts can be considered a genuine substitute since the incentive (reduced input price)

or the sanction (longer working hours, reduced wages) has, to the bank, no cash value: this incentive respecting sanction cannot be negotiated and liquidated in the market nor enforced in courts.

Practically, however, interlinked contracts do not play a major role as collateral substitutes; banks tend not to intervene in the local labour, input or produce markets. The closest that special banks like Grameen or financial NGOs come to "interlinking contracts" is the exclusion of a defaulting borrower from participation in training, advisory or other non-financial services that are occasionally provided along with credit; even these services are not provided on the basis of contracts, strictly speaking. Also, in order to function as an incentive and enforcement device, the borrower must believe to derive considerable benefits from training and other non-financial services, so that the ejection from the credit circuit is effectively perceived as a deprivation. The only type of institution that has internalized inter-linked contracts to some extent are multi-purpose cooperatives, which can ensure repayment by sanctioning the defaulting member in non-financial transactions.

In many instances, the reference to interlinked contracts in the context of bank operations is loose language. What is often meant is "assignment of future income" to the bank, i.e. a perfectly normal collateral instrument.

Again, not much is known about the performance of interlinked contracts seen as pure repayment enforcement device, nor about total transaction costs involved nor about cases where some specialized financial institution would have systematically resorted to such an arrangement. This is probably due to the fact that interlinked contracts are a complex socio-economic arrangement to secure labour supply, maximize rents and respond to input fluctuations. It is difficult to isolate the collateral function within this complex socio-economic context. Another reason for the obscurity surrounding inter-linked contracts may be the exploitation that is hidden behind such a contract. Land owners, traders, moneylenders, but also the indebted labourers will be reluctant to disclose the nature of the contractual arrangement.

Be that as it may, the subject merits further investigation from an equity point of view, even if a full-fledged replication by specialized financial intermediaries does not seem feasible.

3.2.5 Co-maker arrangements without intended enforcement

The last collateral substitute reviewed here is an arrangement similar to a personal guarantee. In contrast to a regular personal guarantee, the creditor has in this arrangement from the beginning no serious intention to execute into the guarantor's property. The guarantor's signature has only an enforcement effect on the debtor; it obliges the borrower to pay back a loan, otherwise the good reputation would be affected.

²⁰ According to W. Steel, BRI (Kupedes) "requires fixed property (farm land) as collateral", but not necessarily for the full amount of the loan.

Illustrations of this type of collateral substitute can be found in the BPD programmes in Indonesia, of which the Badan Kredit Kecamatan (BKK) in Central Java is the best-known. It requires that a borrower obtains the signature of the village head and of a co-signer (Rhyne, p. 7).²¹ The co-signer in the BKK programme can even be co-opted into the system by a "performance bonus" dependent on the profitability of the local BKK unit (Mosley, p. 28). Co-signing, often in combination with probation, is a feature also in the SEWA, UNO, PRODEM, ADMIC, and other programmes (Dessing, pp. 56-58).

Again, while anecdotal evidence seems to suggest that the system works well (GTZ), the information about the actual performance (by whatever standard) of this collateral substitute is unsystematic or dated. It would be of interest to probe further into the stability of arrangements involving local hierarchies with increasing mobility of the rural population.

²¹ A different view is put forward by Pearson/Garland (p. 5), according to whom "signatures . . . from village officials are insufficient in vouching for a person's character . . . ; village leaders have capitalized on the feeling of indebtedness that comes with the approval for a loan" which has brought to the programmes borrowers with questionable character".

4. Findings

While the report failed to find a magic formula in the collateralization of small-scale financial contracts, it has identified the parameters under which lender and borrowers make decisions about the extent and modalities of loan securization. It was found that transaction costs play a major role for both contracting parties. Not much is known about those collateral-related transaction costs. The report has also identified some obstacles to the replication of collateral substitutes normally associated with the informal sector and non-banks. The review of the performance of collateral substitutes concluded with a list of items that need to be further investigated.

The most important specific findings were:

1. Collateral deficiencies are an important constraint for very small-, small- and medium-sized enterprises, but in different ways: while the absence of assets that can be pledged is a major constraint for micro-enterprises, it is the transaction costs for both borrower and lender in establishing and especially enforcing security interests of available forms of collateral that represent an important obstacle for small- and medium-sized enterprises.
2. Lack of collateral can be a constraint also for the lender, namely in a situation when a loan would have been processed, had it not been for high transaction costs associated with the form of collateral offered by the prospective borrower, that cannot be absorbed or otherwise externalized.
3. The informal financial sector is not an island of collateral-free lending. Whether or not collateral is taken in the informal sector depends on the professionalization of the lender, location, the loan size and the familiarity of the contracting parties: at any rate, collateral is taken. For this and other reasons, it is not clear whether informal lending practices are always a reliable guide for the introduction of uncollateralized lending in the formal financial sector. Collateral-free lending in the informal financial market is accompanied by a fairly high level of interest rates, which may be impossible to charge by banks and other supervised financial institutions.
4. Adverse selection problems could very well exist also in connection with collateral-taking: is it the most serious and trustworthy borrower who provides the most compact collateral protection?
5. Collateralization is closely linked to loan size: the larger the loan, the more likely is a collateral requirement; however, the cost of establishing and enforcing security interest is not necessarily related to loan size, but contingent on borrower characteristics and the legal and regulatory framework.

6. The anticipation by the lender of major transaction costs in connection with cumbersome judicial process to liquidate certain types of collateral may have the side effect of further rationing out loan transactions with SMEs.
7. The entire range of collateral instruments is available only for few borrowers; among those instruments available, borrowers prefer those with minimum transaction costs, nuisance, incidence on business and social exposure shame. Lenders prefer collateral instruments that are easily marketable, rapidly appropriable and entail hardly any transaction costs.
8. There is a wide range of views of what "collateral substitutes" means: some emphasise the extent of replacement of a conventional form of collateral; others focus on the method of enforcement (legal, para-legal); yet others the marketability of the pledged asset. Some propose to use the combination of these features as qualities of a genuine substitute. In view of their incidence on small and micro-businesses' access to credit, two criteria are retained for the purposes of this report, namely enforceability by extra-legal means and zero marketability.
9. Some collateral substitutes like joint liability, probation and informal co-maker arrangements seem to provide access to the financial market for first-time borrowers; group formation and other intermediary functions taken over by an NGO or self-selection mechanisms help reduce and externalize lender transaction costs.
10. Bank acceptance of collateral substitute is enhanced by two factors: scope for externalising transaction costs (self-selection or group formation by a NGO) and the freedom to compensate for the supplementary risk by a premium on top of the interest rate.
11. Government-owned banks, NGOs that have transformed into banks and financial NGOs have been found to use collateral substitutes, but usually not commercial, private banks.
12. Collateral substitutes seem to perform equally well – if not better – than conventional collateral in protecting lenders against default. This applies particularly to peer monitoring which is a substitute that has been successfully used in a number of financial institutions, primarily in Asia, over a considerable span of time: this applies to special schemes with external refinancing resources and – more significantly – to mainstream operations on own resources.
13. Collateral is governed by different legal fields: there is no collateral law as such; civil law (or rather the way the law is administered in contract law, property law, bankruptcy law, law of judicial process). Public law and Central Bank regulations are surprisingly unspecific about collateral issues.

14. Collateral law influences the choice of collateral instruments by contracting parties via the way judicial process, registers and other dispositions are administered, entailing projection and anticipations of more or less substantial transaction costs for both borrower and lender. In some cases, Central Bank decrees have been found to play a role in disseminating information about extra-legal enforcement mechanisms, thus indirectly encouraging financial institutions to deal with first-time borrowers.

5. Conclusions

1. Not all forms of collateral are equally accepted by banks: their preference is determined by present and anticipated transaction costs in establishing and enforcing property rights, the ease of liquidation and the position vis-à-vis other creditors in case of insolvency. Because of differences in legal systems and local markets, there are considerable variations within and among countries.
2. Lack of collateral is a major constraint for small- and micro-enterprises, and especially new entrants to the financial market; it is also a constraint for banks to the extent that it prevents the financing of (probably) safe small-scale investments. Lack of collateral is also a concern for public authorities supervising the financial sector in the sense that it may lead to a suboptimal flow of bank credit to certain sectors of the economy.
3. In principle, there is a close link between loan size and the extent and quality of collateralization: the larger a loan, the more the bank will be inclined to require a form of collateral that retains its value over time and that can be easily sold, taking into account the respective transaction costs involved.
4. Transaction costs in connection with collateralization can be considerable. Banks try to externalize some of these transaction costs to the borrower or to an intermediary; banks also seek to compensate for insufficiently attractive collateral by charging higher interest rates, wherever that is possible.
5. Confronted with the lack of collateral, several intermediaries have tried to come up with "substitutes". The definitions of what constitutes a "collateral substitute" differ. For the purposes of this report, a genuine collateral substitute has two characteristics: it is not enforceable through the formal judicial process and it cannot be sold in a market.
6. The best-known examples of collateral substitutes are peer pressure, probation (credit scoring), interlinked contracts and co-maker arrangements without intended enforcement. For some institutions, collateral substitutes have become the major loan securing technique, and this over a fairly long period. Whether they are effective or not is a question of repayment performance by borrowers, transaction costs and bank-internal acceptance ("mainstreaming").
7. Peer pressure and probation (credit-scoring) are fairly well documented substitutes: peer pressure (joint liability arrangements) is widely used by financial NGOs, government-owned banks and rural banks. Its performance in terms of ensuring adequate repayment is not inferior to more conventional instruments. Probation mechanisms (credit-scoring) for individual borrowers are less

widespread, but appear to function equally well. Little is known about the transaction costs involved in the four substitutes reviewed.

8. Further work is required on collateral-related transaction costs, the stability of joint-liability groups and the actual extent of collateral-free credit-scoring. Such work should cover both bank-internal cost functions and external factors like judicial process in connection with repossession and registers. Donors can play a key role in integrating collateral issues in financial sector reform and liberalization programmes. The dialogue on collateral issues should involve banks, public authorities (including Central Banks), support NGOs and representative organizations of micro and SMEs.

Open issues

- Can efforts to reduce transaction costs due to judicial process be efficiently combined with the identification and wider use of collateral substitutes?
- Do modifications of collateral in the legal and regulatory environment also affect micro-finance outside the formal financial sector?
- Is there a link between the degree of targeting and the use and effectiveness of collateral substitutes? And if so, what are the implications for governments and aid agencies that impose or suggest targeting?
- If banks could charge any interest rates to compensate for the risk of undercollateralized lending, would that make a difference to the volume of small-scale businesses (K. Hoff, p. 238; World Bank)?
- Would efforts to mobilize savings make collateral substitutes redundant? Or policies to help the shift from real to financial savings (van Rijn)?
- Why is it that leasing, hire purchase arrangements, franchising are not more extensively used as "collateral substitutes" (van Rijn, Steel)?
- Accepting that there is a (social) benefit to increased market access of undercollateralized MSE, what kind of incentives are most effective for banks that come up with innovative approaches to collateral or that subcontract NGOs which themselves operate with collateral substitutes?

Recommendations

Central Banks

- Collateral substitutes are for first-time borrowers a bridge to the financial market; in view of the scope of collateral substitution for financial sector broadening, public authorities and especially Central Banks may wish to collect data about ongoing experiments and open a dialogue with commercial banks.
- In particular, Central Banks may wish to set up observatories to study longer term changes in the competitiveness of rural financial markets with the accompanying impact on joint liability groups stability.
- Central Banks may wish to explore evidence of cost-reducing measures in connection with collateral, for example staff incentive schemes, subcontracting to non-banks and decentralization of approval authority, etc., and then inform the banking sector about the results.
- Credit referral systems – if adjusted to small-size transactions – can play a major role in accompanying collateral substitution; Central Banks could review the costs and benefits of such systems and encourage their adoption within banking groups and across the financial sector.
- It is not clear to what extent credit scoring is a genuine collateral substitute; in many banks, especially in developed markets, it is a way to simplify and standardize transactions of a repetitive nature, thus reducing transaction costs without, however, completely doing away with the need to establish collateral; Central Banks could collect information on the effectiveness of credit-scoring as a technique to minimize default risk and encourage banks to learn more about it.
- Examine – together with banker associations and others – the effectiveness of (limited) interest rate liberalization as a means to increase bank spread to compensate for special risks.

Representative organizations of SMEs and microenterprises

To the extent that such organizations have members already with bank contacts – even if these are precarious – their concern will be that banks accept available forms of collateral. As this acceptance is largely determined by bank transaction costs, the interests of these organizations will

largely coincide with those of public authorities, i.e. provide banks with as much information as possible about what works as collateral instrument at what costs. Vis-à-vis their members such organizations should take a lead and disseminate accessible information about comparative costs and benefits of collateral instruments.

Banks

- may not be well informed about the actual transaction costs and effectiveness of collateral instruments (including collateral substitutes); they may wish to assess their transaction costs with regard to specific collateral instruments, identify the scope for cost reductions and implement them;
- should voice their concern to public authorities concerning unduly long judicial process in connection with repossession and with the state of registers;
- in the light of experiences made within certain bank groups and by non-banks (NGOs), banker associations could issue to their members leaflets on collateral substitutions (case studies);
- may wish to examine the feasibility of expanding credit referral systems to smaller-loan transactions;
- review the possibility of collateral-free credit-scoring.

Government (Ministries of Justice, Finance, Economy)

- should ensure that collateral law reform takes transaction costs aspects into consideration;
- should – in the framework of law reform – systematically review the scope for simplifying existing procedures for establishing security interests, but also study para-legal instruments used in connection with collateral substitutes (accelerated court orders, updated registers);

Policy and practical issues for donors

- Donor agencies may wish to become better and regularly informed of the significance of collateral constraints for targeted micro-finance programs, especially the costs attributable to the enforcement by judicial process of different forms of collateral.

- Beyond integrating collateral substitution into their financial sector development policies, donors could initiate a dialogue with partner Governments on the need for specific collateral policies (including law reform, administrative reform, creation of specialized intermediaries) or the accommodation of collateral issues into the framework of other policies affecting the financial sector, for example savings mobilization and interest rate measures.
- Donors and partner Governments alike may have an interest to integrate collateral substitution especially into financial sector reform measures, in the light of its impact on the access of new entrants to the financial market.

The following grey areas that lend themselves for immediate further investigations have been identified:

- borrower transaction costs in connection with different forms of collateral;
- factors that explain the reluctance of commercial banks to adopt more readily innovative loan securization techniques (lacking competition, interest rate regulations);
- the effectiveness of the individual probation approach in terms of repayment rate, transaction costs and borrower graduation;
- the mechanisms of interlinked contracts in multi-purpose cooperatives;
- mainstreaming of collateral innovations within and between banks;
- the effects of group drop-outs;
- collateral law with regard to the introduction of substitution and transaction costs.

After consultation of the members of the Donors' Working Group, the following priorities for further work have been set:

1. Lender transaction costs of different forms of collateral substitutes.
2. Idem, but for collateral in general.
3. Borrower transaction costs in connection with collateral substitutes.

4. Effectiveness of collateral substitutes (other than peer pressure) like probation/credit scoring/interlinked contracts/co-maker arrangements.
5. Effectiveness of peer pressure over time (group drop-outs).

Glossary

Account: *A detailed statement of the mutual demands in the nature of debit and credit between parties, arising out of contracts or some fiduciary relation.*

Assignment: *The act of transferring to another all or part of one's property, interest, or rights.*

Bailiff: *One to whom some authority, care, guardianship, or jurisdiction is delivered, committed, or intrusted.*

Chattel mortgage: *A transfer of some legal or equitable right in personal property or creation of a lien thereon as security for payment of money or performance of some other act, subject to defeasance on performance of the conditions.*

Collateral: *Property which is pledged as security for the satisfaction of a debt. Collateral is additional security for performance of principal obligation.*

Collateral law: *Largely civil law dispositions that affect the creation, perfection and enforcement of collateral (security interests).*

Collateral substitute: *A pledged good, right or title that is neither marketable nor legally enforceable, but works as an incentive, screening and sanction mechanism to ensure repayment of a debt.*

Conveyance: *In its most common usage, transfer of title to land from one person, or class of persons, to another by deed.*

Co-signer: *Person who signs a document or instrument along with another, often assuming obligations and providing credit support to be shared with other obligor(s).*

Deed: *A written instrument, signed, and delivered, by which one person conveys land, tenements, or hereditament to another.*

Foreclosure: *To shut out, to bar, to destroy an equity of redemption.*

Guarantee: *An agreement in which the guarantor agrees to satisfy the debt of another (the debtor), only if and when the debtor fails to repay (secondarily liable).*

Homestead clause/exempt property laws: *Laws passed in most states allowing a householder or head of a family to designate a house and land as his homestead, and exempting the same homestead from execution by creditors for his general debts.*

Interlinked contract: *A system by which a creditor can ensure repayment by modifications in the terms of labour, input supply, produce marketing and other contracts that provide links to the same debtor.*

Joint liability: *Liability that is owed to a third party by two or more other parties together.*

Loan delinquency rate: *Outstanding balances of loans with payments late over 90 days.*

Pawn: *A pledge; a deposit of personal property made to a pawnbroker as security for a loan.*

Pledge: *A bailment, pawn, or deposit of personal property to a creditor as security for some debt or engagement.*

Post-dated check: *A check issued before the stated date of the instrument. One delivered prior to its date, generally payable at sight or on presentation on or after day of its date.*

Promissory note: *An unconditional written promise, signed by the maker, to pay absolutely and at all events a sum certain in money, either to the bearer or to a person therein designed or his order, at a time specified therein, or at a time which must certainly arrive.*

Redemption: *The right of a debtor, and sometimes of a debtor's other creditors, to repurchase from a buyer at a forced sale property of the debtor that was seized and sold in satisfaction of a judgement or other claim against the debtor, which right usually is limited to forced sales of real property.*

Risk premium: *Extra interest paid to a lender, over amounts usually considered normal, in return for their undertaking to engage in activities more risky than normal.*

Security: *An obligation, pledge, mortgage, deposit, lien, etc., given by a debtor in order to assure the payment or performance of his debt, by furnishing the creditor with a resource to be used in case of failure in the principal obligation.*

Security agreement: *An agreement which creates or provides for a security interest between the debtor and the secured party.*

Security interest: *Interest in property obtained pursuant to security agreement.*

Surety: *One who at the request of another, and for the purpose of securing to him a benefit, becomes responsible for the performance by the latter of some act in favour of a third person, or hypothecates property as security therefore.*

Title deeds: *Deeds which constitute or are the evidence of title to lands.*

Writ of execution: *Formal, written command of a court directing a sheriff or other official to enforce a judgement through process of execution.*

Taken from: *Black's Law Dictionary* (St. Paul, 1990)

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Annex: Survey responses by members of the Donors' Working Group

List of Respondents:

Canadian International Development Agency (CIDA), Quebec, Canada: *G. Lessard*

Danish Ministry of Foreign Affairs, Copenhagen, Denmark: *T. Lindqvist*

Dutch Ministry of Foreign Affairs, Den Haag, the Netherlands: *Fr. van Rijn*

European Commission, Brussels, Europe: *P. Logli*

Giordano Dell'Amore Foundation, Milan, Italy: *F. Tambussi*

Gesellschaft für Technische Zusammenarbeit (GTZ), Eschborn, Germany: *A. Hannig*

International Development Law Institute (IDLI), Rome, Italy: *M. E. Footer*

Kreditanstalt für Wiederaufbau (KfW): *Mr. W. Neuhauss*

Norwegian Royal Ministry of Foreign Affairs, Oslo, Norway: *A. Eidhammer*

Swedish International Development Cooperation Agency (Sida), Stockholm, Sweden: *J. Runnquist*

Swiss Agency for Development and Co-operation (SDC): *R. Avanthay (India), R. Brugger (Bolivia), B. Girardin (Pakistan)*

United Nations Development Programme (UNDP): *H. Jackelen*

U.S. Agency for International Development (USAID): *V. White*

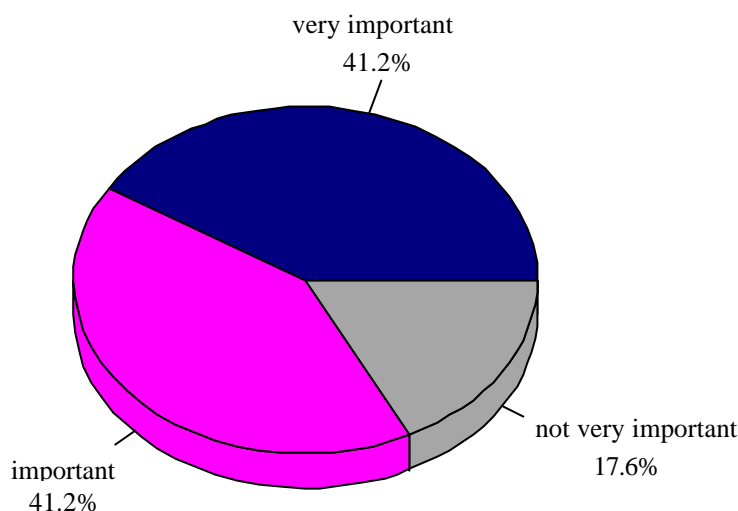
Women's World Banking: *R. Goodwin*

World Bank: *W. Steel, J. Yaron*

Answers:²²

1. Please, rank the importance of the collateral issue in the light of your experiences with SE promotion and other targeted programmes:

Importance of collateral issue



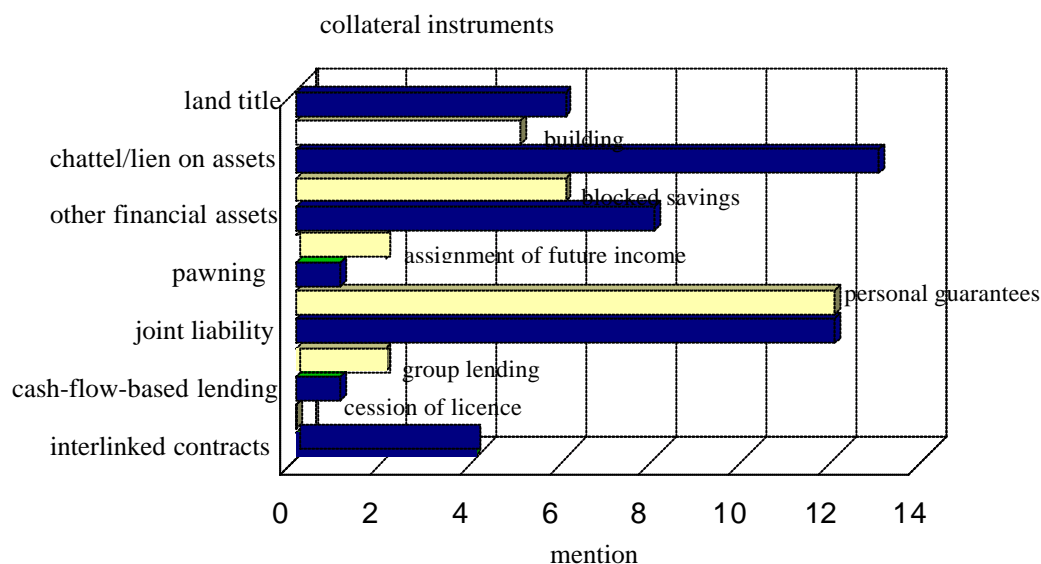
USAID: “Because differences in lending practices and legal and regulatory frameworks exist both between and across geographical regions, it would be difficult if not misleading to try to broadly categorise the “collateral issue”. In general, however, the “collateral issue” defined within the framework of collateral law and collateral substitutes, offers an important explanation to the reluctance by many developing countries’ formal banks to lend to small farms and businesses. In Latin America, in particular, the tight link between access to credit and ownership of real estate, largely due to deficiencies in laws concerning collateralization, precludes many micro and small scale entrepreneurs from securing bank loans. Such legal deficiencies, however, do not pose significant problems in most of Asia. Instead, the high cost associated with collecting pledged collateral relative to the size of the micro loans is often cited by banks as a principal deterrent to pursuing SE lending. Within the larger context of SE promotion, the growth of informal sector lending programs, which typically rely on collateral substitutes as a means of targeting the poor, has greatly improved access to credit for many micro and small-scale businesses throughout the developing world. These

²² Fifteen member agencies responded, sending in a total of eighteen answers, of which one could not be included in the analysis due to a different format. The visualization of the results is meant to serve as an illustration. The citations are to show the broad spectrum of views by members of the Donors' Working Group on Financial Sector Development related to the collateral issue.

lenders typically have stronger relationships with the borrowers and are able to exercise more control over the borrowers' activities. They are also willing to accept a much wider range of collateral to support their loans than banks are. As such, while the collateral issue may limit access to formal bank credit, it presents much less of a constraint to borrowers operating outside the formal banking sector, particular microenterprises.”

2. *The following is a preliminary list of collateral instruments, some of which are used more often than others in small-scale lending. Some are conventional, others quite unusual, at least in formal financial contracts. Seen in the context of small-scale finance in general, does your agency have experiences with any particular of the above-mentioned collateral instruments? Which?*

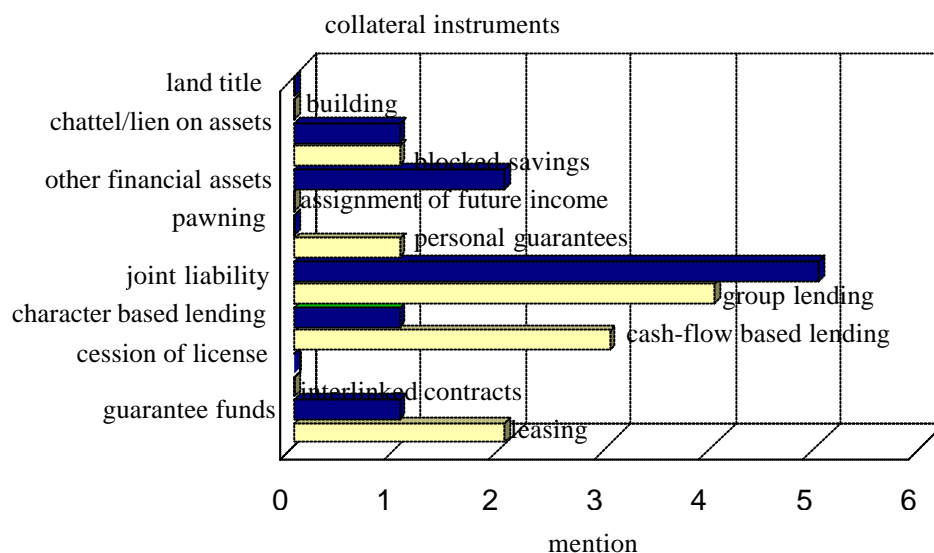
Experience with collateral instruments



World Bank (Steel): “Targeted credit programs have tended to be at two extremes: SME credits through banking systems rely on banks’ standard collateral requirement, usually legal title to land or building. I don’t think we impose a requirement on them, but since they bear at least some of the risk, their normal requirements come into play. On the other extreme, “revolving funds” and income-generating credit schemes as part of social funds and welfare-oriented projects tend not to have any collateral requirements, except perhaps personal or group guarantees.”

3. In the light of these experiences, does your agency have a preference for particular types of collateral? Or collateral substitutes? If so, please explain and illustrate.

Preference of responding agency for collateral type



Danish Ministry of Foreign Affairs: “Land titles have very limited applicability as security. Purchased assets in combination with joint liability may offer perspectives.”

Dutch Ministry of Foreign Affairs: “here are no particular types of collateral excluded except for the use of homestead. As these are hard to realize and if realized have a strong adverse social effect, it is better not to include them in the list of acceptable collateral.”

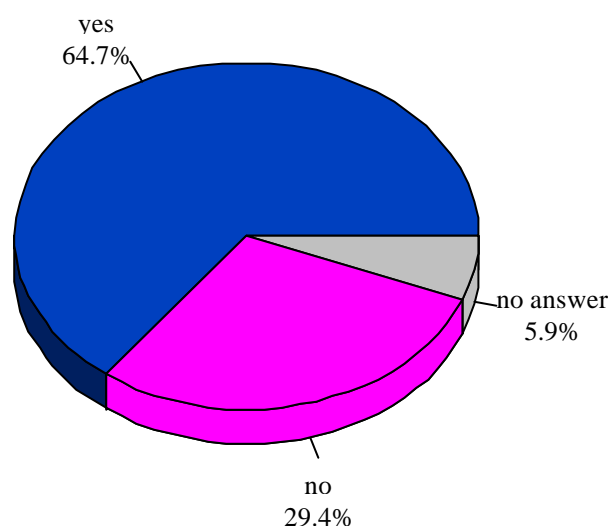
USAID: “With regard to microenterprise lending, USAID’s Microenterprise Development Guide states: ‘Serious issues exist about the relative merits of these different approaches, and this guidance imposes no preference for one over the other. However, reliance upon some form of collateral substitute provides an important means for MFIs to ensure that the poor have access to their services. As a result, a mission considering providing assistance to a financial institution that does not rely upon a collateral substitute should seek additional evidence that the institution is actually reaching poor customers’”.

World Bank (Steel): “Neither type of experience has proven very satisfactory in terms of recovery rates. Banks rarely attempt to recover fixed property as collateral, at least in most African countries, where the legal system is not well designed for business law, costly, slow, uncertain, and subject to manipulation. (South Africa seems to be an exception; contract enforcement is quite effective. Reportedly, even informal moneylenders can use the legal

system to enforce written contracts to repay a given sum of money - even though the implicit, but not written down, interest rate might be technically in violation of the Usury Act.) There has been growing interest in leasing as a way to avoid these collateral problems for SMEs. This enables them to substitute a leasing contract (with the equipment itself as collateral) and avoid having to borrow to purchase the asset (in which case they have to put up property as collateral). Repayment rates in micro credit components of social loans have not been very satisfactory. The Bank is now emphasizing that such components should be designed in accordance with best practices in macro finance, as embodied in the Guiding Principles of the two donor committees, including methodologies such as blocked savings accounts and use of solidarity group guarantees as collateral substitutes.”

4. *In those projects implemented by your agency that involved banks, was the provision of collateral by the target group always a constraint? If so, please explain and illustrate.*

Collateral as a constraint



Dutch Ministry of Foreign Affairs: “In the case of individualized loan facilities through banks there has always been the feeling of being restricted by a lack of 'quality' collateral. In particular for customers without relatives who live in urban areas and own developed plots, and customers who live in areas where land titles or long term leases have not been issued the lack of availability of a prime collateral such as land is felt.”

GTZ: “No, but an excuse for rejection of loans (social distance of formal bankers, small, unattractive and cost-intensive loans).”

KfW: “We received few complaints, if any in this respect. We have a feeling that banks took what they got, but there is always the problem of turning assets in cash.”

Norwegian Royal Ministry of Foreign Affairs: “No. For good projects with well qualified management, security is a lesser problem than for more risky projects.”

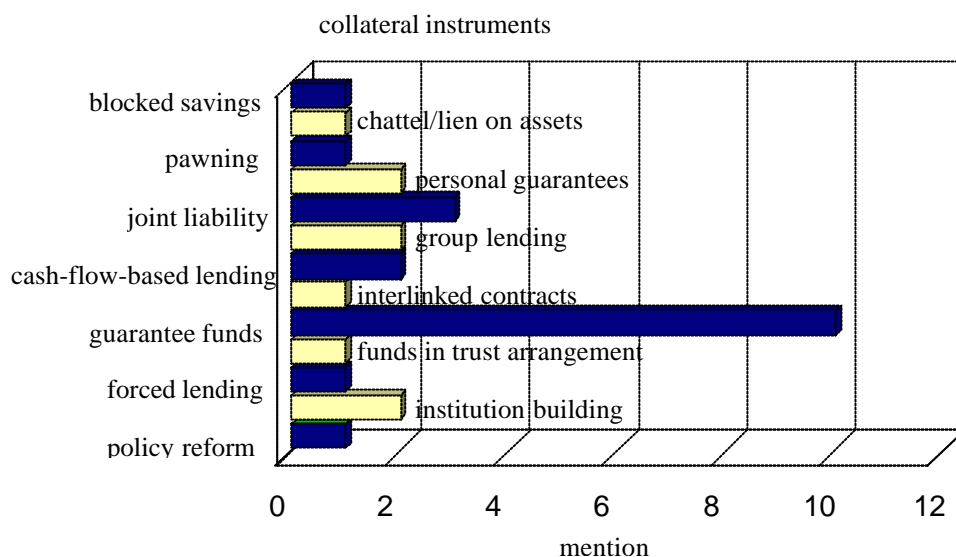
Swiss Agency for Development and Co-operation (Avanthay): “Yes it was. When micro-entrepreneurs can not include their credit request in a ‘bulk request’ channelled by a SHG or an NGO to the bank, in most cases the lack of collateral will prevent them from having access to credit.”

USAID: “In general, the provision of collateral by the target group has posed a significant problem to those projects involving banks. Given the reluctance by formal banking institutions to accept collateral substitutes, the provision of collateral typically remains a constraint to poor borrowers. To mobilize credit through the formal financial sector for these poorer borrowers, USAID has traditionally established loan guarantee programs. Recently, however, in Eastern Europe, USAID has attempted to directly address the legal and regulatory framework governing collateral.”

World Bank (Steel): “Lack of collateral satisfactory to banks has almost always been a constraint on disbursement of World Bank SME lines of credit. It lies behind the typical situation in which the participating banks say that ‘there is not enough bankable demand’, even though our assessments indicate an excess demand for finance by viable, dynamic SMEs. But this is not always the case. For example, we have had very successful SME finance programs in Sri Lanka and Ecuador. I am not sure offhand about the collateral requirements of the participating banks. But I believe that in Sri Lanka they gave a high degree of responsibility and authority to local branch managers, and this may well have included substituting first-hand personal knowledge of the business for formal collateral requirements. (For this to work, branch managers have to be directly rewarded or penalised depending on the performance of their SME portfolio.) Another successful Bank-supported small credit project has been the KUPEDDES (Unit Desa) program of Bank Rakyat Indonesia. They do require fixed property (farm land) as collateral, but I am not sure that this has to cover the full amount of the loan; in any case, personal knowledge of the client by the bank staff is at least as important as formal collateral. These staff share in the profits of their unit bank, so have a strong incentive to make good loans and collect them.”

5. *How was the collateral constraint resolved?*

Approaches to resolve collateral constraint



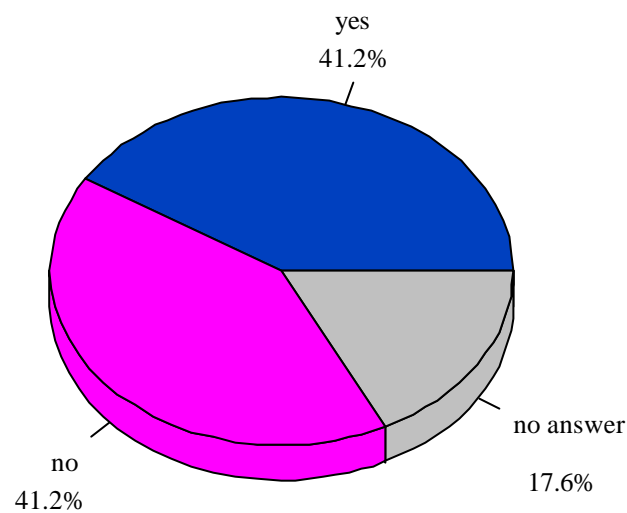
USAID: “The following two examples are representative of USAID’s approach to the collateral issue within the formal banking sector: (1) Loan Guarantee Program in South Africa (. . .); (2) Policy Reform in Eastern Europe: The purpose of the USAID funded IRIS-Central Europe project is to create a positive commercial law institutional framework for the development of the financial sector in Poland, Lithuania, Macedonia, Bulgaria, Croatia and Albania. This purpose is being accomplished by assisting these countries to reform their collateral and bankruptcy laws. In Bulgaria, for example, the Collateral Law Reform Project has recently been launched to address two fundamental problems: the transfer of possession rule, which states that movable property can only be used as collateral for a loan if the debtor transfers possession of the property to the creditor, and the absence of a registry to record the use of movable property as collateral, which makes it impossible to determine whether another lender has a prior claim to the collateral. To address these issues, the IRIS project has targeted four objectives: (1) help Bulgarian experts draft a modern collateral law, (2) help develop a collateral registry, (3) help train people to use the new law and registry, and (4) help people understand why commercial law reform is important.”

World Bank (Steel): “Collateral constraints have sometimes been dealt with by raising the ceiling on loan size, which dilutes the objective of reaching smaller clients (but recognizes that this may not be achievable without a change in banking methodology to find good collateral substitutes). The solution that banks tend to propose is a Guarantee Scheme. (. . .) The World Bank generally opposes guarantee schemes as a solution. If the guarantee is too high (above 50-60%), moral hazard problems arise, diluting the bank’s incentive to screen

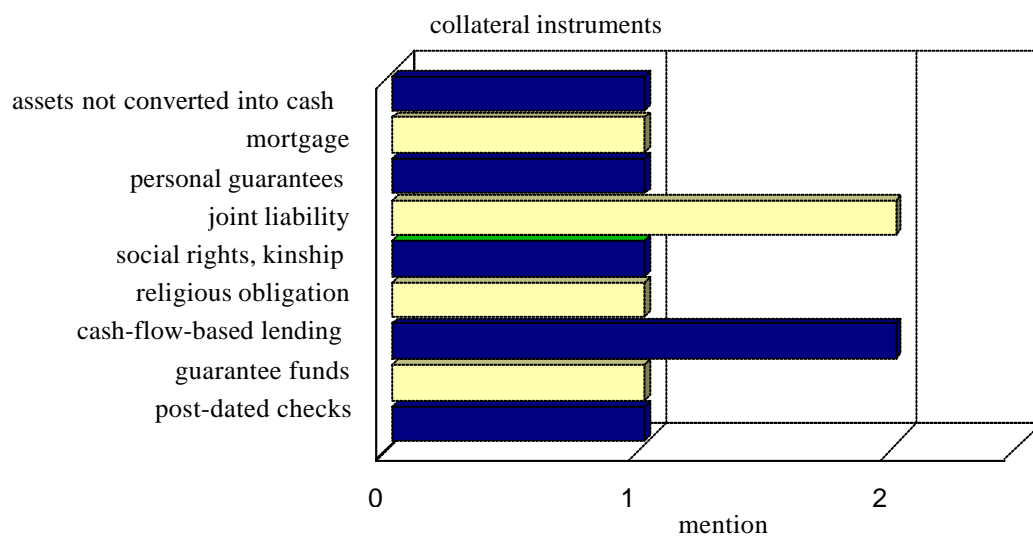
loans adequately or pursue defaulters and reducing borrowers' incentive to repay. In such cases, guarantee schemes tend to decapitalize and be unsustainable. If the guarantee is low, bureaucratically cumbersome, inadequately funded, etc., it may have little impact on behaviour."

6. *Have you seen banks adopt innovative collateral instruments? If so, with what results? Could you provide details?*

Adoption of innovative collateral instruments by banks...



... these were mentioned by respondents replying with 'yes'



GTZ: “In general good results, much better than results of operation based on traditional collateral forms (land, house, etc.).” (In reference to “Mortgage with/without possession; social rights inside village communities, kinship; religious obligation formula”.)

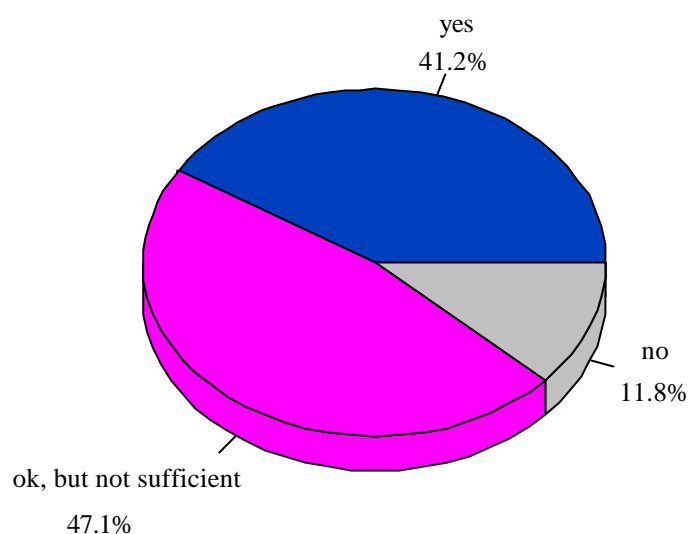
Swiss Agency for Development and Co-operation (Avanthy): “Self-help-groups with a 100% recovery but with the support of apex-banks supporting at concessional rates NGOs which in their turn on-lend to SHGs”.

USAID: “The solidarity group methodology acts as a key screening mechanism and is a substitute for collateral at such banks as BancoSol and the Grameen Bank. As has been well documented, this type of collateral substitute has proved during the last few years to be effective in reconciling the competing pressures of serving the very poor and operating in a self-sustaining manner. The general reluctance by banks to accept collateral substitutes, however, is not solely due to a lack of innovation among the banks themselves. Instead, the lack of reform of the regulatory and legal environment has prevented banks from accepting most forms of movable property as collateral. For example, restrictions on or imperfections in pledging movable property as collateral, inadequate registration of collateral and lien rights, difficulties in and costs of ascertaining title of goods, and the slowness and underdevelopment of enforcement and regulatory mechanisms all increase, instead of reduce the risks associated with lending against non-traditional collateral. In addition, the supervisory treatment of traditional collateral versus collateral substitutes has a negative impact on bank lending to the micro and small business sectors, because collateral substitutes are difficult to register and repossess, the loans against which they are pledged are typically classified by banks examiners as high risk assets. As a result, banks are forced to increase their capital base when making such loans in order to maintain minimum capital adequacy requirements.”

Women’s World Banking: “Most innovative is cash-flow-based lending - they are learning.”

7. *Do you think the collateral problem can be resolved by modifications in the legal and regulatory environment?*

Desirability of modifications in the legal and regulatory environment



Danish Ministry of Foreign Affairs: “Such modifications are usually a necessity, but not a sufficient condition. Behavioural changes in financial institutions will still need to be induced.”

Dutch Ministry of Foreign Affairs: “Relaxation or modifications of the legal and regulatory environment will often not be the solution. Stricter rules protect the banking sector against accepting too high a risk. In that respect relaxing the rules would pose the danger of running the risk of bankruptcy which will make the other banker even more risk evasive and will reduce the client's willingness to save with the banks. As banks often go for a higher than 100% security cover, relaxation of the rules and regulations will not solve the problem anyway. Efforts to expand the volume of investable funds (savings mobilization, redirecting credit from the public to the private sector, monetarization of savings, etc.) will be necessary in conjunction with reviewing individual conditions that are felt to be too harsh.”

Giordano Dell'Amore Foundation: “We do not think that this issue could be solved by degree because the problem is closely related to how the banks approach the customers.”

GTZ: “If customary right applied, no! Legal and regulatory reforms are important, but only in connection with the introduction of innovative financial technologies.”

KfW: “Yes, in cases where the law 'over'protects the borrower.”

Norwegian Royal Ministry of Foreign Affairs: “In some cases it will help, if the banks can more easily realise the collateral.”

Swiss Agency for Development and Co-operation (Avanthy): “Yes. The regulatory environment should be reformed in such a way that more importance is given to joint liability (micro level) or business potential (small level).”

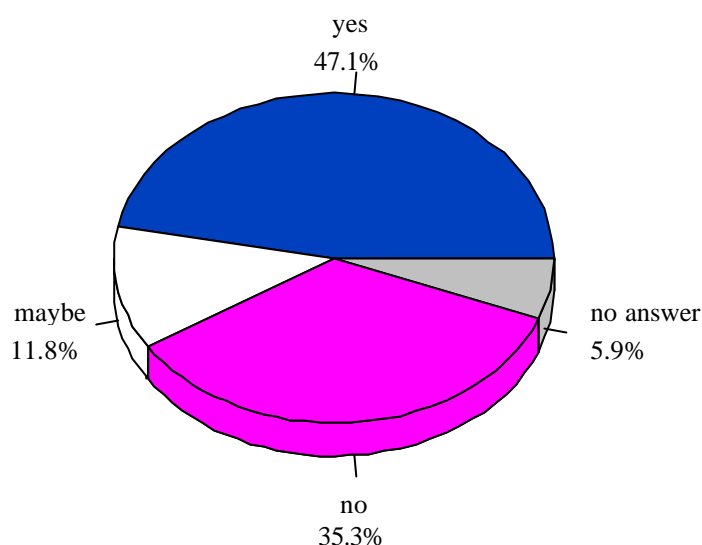
USAID: “Appropriate modifications in both the legal and regulatory environment can have a significant impact on improving, though not necessarily resolving, the collateral problem, as banks will still have to seek alternatives to collateral or collateral substitutes in order to reach those without marketable assets. Legal and regulatory constraints include the following: barriers to using registry systems, usury laws which discourage lenders from making small loans, and cumbersome restrictions to repossessing pledged collateral. In Bolivia, for example, homestead and exempt property provisions make the land and equipment held by poor families unacceptable as collateral. In addition, as mentioned above, traditional asset review procedures used by bank superintendents need to be re-examined in light of both the increases role these institutions are beginning to play outside the formal banking system and the growth in collateral substitutes among microfinance institutions.”

Women's World Banking: “Not the most important factor. Banks can be more flexible (. . .), if they want to be. The key is understanding that the clients are a good credit risk.”

World Bank (Steel): “Assets are weighted by riskiness in determining key ratios for supervising bank performance, and loans that are not secured by titled property generally are counted in a higher risk category than those that are ‘properly’ secured. So bank restructuring programs that strengthen the regulatory environment can have the consequence of making banks pay even stricter attention to collateral. The preceding may explain the apparent anomaly that banks require titled property as collateral even though they complain that it is virtually unenforceable in a given country's legal environment (or social, where it would be unacceptable to evict people from their family home). Certainly, it is critical for private sector development generally (not just collateral) to improve the legal and regulatory environment for enforcement of contracts. But that is a slow process, so really should be seen as long-term solution. A more promising short-to-medium term approach may be in hire-purchase and leasing laws, to make it easy to recover movable asset if payment are not made (without having to get a separate court order or warrant).”

8. *Does the collateral problem call for policy interventions, e.g. (fiscal) advantages to induce banks to adopt collateral substitutions?*

Policy interventions required?



Danish Ministry of Foreign Affairs: “What about the creation of guarantee funds?”

Dutch Ministry of Foreign Affairs: “When and where banks would feel that reform of collateral law or the incentive system would make financing less collateralized smaller enterprises more worthwhile (and without getting exposed to high risks), policy interventions may be useful. Policy changes only increase the bank’s flexibility on the collateral issue which would not be useful if the financial risk involved would not be reduced at the same time.”

Norwegian Royal Ministry of Foreign Affairs: “Banks cannot be expected to increase risk of not screening the loans. The depositors’ interests must be safeguarded.”

Sida: “Yes, until they see for themselves that it is possible to work without collateral.”

Swiss Agency for Development and Co-operation: “Yes, besides banking regulations to prohibit vinculated loans” (*Brugger*); “Possibly for a certain period (2-5 years) so that bankers would realize that supporting promising businesses is more important than refrain from doing it because of the lack of collateral” (*Avanthay*).

USAID: “As discussed above, one of the principal reasons banks are not accepting collateral substitutes is the country’s legal and regulatory framework. Collateral substitutes are often time-consuming and costly to collect, in the event a debtor fails to service a debt. In addition, most developing countries do not maintain centralized public registries, facilitating fraudulent pledging activity. Given these legal realities, banks have tended to treat

such loans as unsecured. As such, they have either compensated for this predetermined risk by charging higher interest rates, or have chosen to avoid such collateral substitutes altogether. While offering fiscal advantages to banks may provide some short-term incentive to banks, such a policy does not address the root of the problem as explained above, nor does it address longer-term institutional changes which may be needed. In addition, such 'fiscal advantages' often serve only as green lights to approve loans which hold significant risk."

World Bank (Steel): "I am somewhat sceptical about fiscal incentives for banks to waive collateral. If banking regulations are the fundamental issue, this won't help much. If banks really aren't interested in SME loans, then measures such as guarantee funds may have to be too large to be sustainable or may encourage imprudent behaviour."

9. *What do you think are the implications of the collateral problem for donors interested in the development of the financial sector in developing countries?*

CIDA: "More resources for training and for capacity development (lenders with experience in the private / productive sectors)."

Danish Ministry of Foreign Affairs: "Needed: Constant pressure for innovative approaches, increased importance of better risk management techniques."

Dutch Ministry of Foreign Affairs: "Donors should pay more attention to interventions directed at reducing transaction costs and improving the environment in which banks have to operate such as the enforcement of contracts. In such situations one would not need to look for over-securing loans and would be more flexible in accepting shared collateral."

European Commission: "We need a dialogue with other donors."

Giordano Dell'Amore Foundation: "It is not easy to distinguish between development objective and charity objective."

GTZ: "No export of ready-made solutions from industrialized countries, identify local solutions, customary rights-based approaches and existing practices."

KfW: "I believe, that the problem of collateral cannot be seen as a separate one from the whole lending technology used by the bank. The better it manages character or cash-flow-based lending, the more it will reduce attention paid to collateral."

Norwegian Royal Ministry of Foreign Affairs: “Collateral is not the problem. Pushing credit is a problem. Lack of savings is a problem. Lack of good projects also. Banks must recover the loans given out, because the money belongs to the depositors or the banks’ other creditors.”

SIDA: “Collateral should be restricted to large loans. Donors should stress better measures for screening, peer pressure, etc.”

Swiss Agency for Development and Co-operation: “(a) Reach a critical mass of successful SHGs to have a demonstration effect; (b) support human and institutional development of banks to train their staff in credit appraisal, understanding of clients/potential clients needs, marketing of credit; (c) diversify the offer of financial services including guarantees, cash credit, credit cards; (d) support innovative private banks and/or no (. . .)” (*Avanthay*); “(a) Action at the level of central banks; (b) support to alternative financial institutions; (c) conscientization of borrowers through NGOs” (*Brugger*); “Uneasy to comment at that stage; possibly: extension of guarantee schemes” (*Girardin*).

UNDP: “Not the fundamental issue.”

USAID: “A two-pronged approach is recommended: support policy changes in the formal banking system (collateral law reform, registry development, etc.) and encourage a wider use of collateral substitutes (leasing, group guarantees, etc.). Guarantee mechanisms or subsidies should not be relied on to address the collateral problem. Both of the proposed approaches need to include greater best practices research and information dissemination, as well as increases support for efforts aimed at forming linkages between the formal banking sector and microfinance institutions. Because of weak linkages and a lack of coordination between intermediary financial institutions and formal financial institutions and among the microfinance NGOs themselves, the different components of the financial system tend to operate in isolation of each other. By encourage bank-microfinance linkages, donors can support the realization of such benefits as information networks, credit referencing and the increased recognition of successful collateral substitutes.”

World Bank (Steel): “Rather, I think the solution is an encouraging development of innovative (no-bank) intermediaries that use methodologies that do not depend on fixed property as collateral. This works best at the micro finance level - methods such as solidarity groups and accumulating savings accounts to hold on reserve against loans. In some country contexts, personal guarantees may work - e.g., the LPDs in Bali, where the village head has

to guarantee each loan, and is also on board or loan committee of the community bank (and has sufficient authority to induce to the family of a defaulter to make good on the debt). The growing number of NGOs that are transforming into some type of banking institution in order to expand their operations (and take savings deposits) is a positive development that should be encouraged. This means revising banking laws and regulations to permit different types of banking and no-bank institutions that are subject to different minimum capital requirements and regulatory requirements from commercial banks. This doesn't mean less stringent requirements, but rather recognition that their methods -- such as collateral requirements -- may be different, so performance standards should be designed accordingly. Donors should therefore support: (a) micro-finance institutions, based on their performance in terms of sustainability and outreach, particularly in transforming into full-fledged financial intermediaries; (b) rethinking of banking laws and regulations to accommodate a wider range of institutions, with different methodologies, and appropriate levels of regulations (or exemption from regulation, for small informal or 'common bond' activities)."

World Bank (Yaron): "To initiate research program that would eventually redesign legal systems in countries where collateral issues impede financial intermediation."