Credit where credit is due:
How collateralized lending in the Americas helps MSMEs grow

By Laura Dawson[1]

Summary/Abstract

Collateralized lending is the catalyst to transform informal, micro-enterprises into small businesses. Small and medium enterprises (SMEs) are the greatest beneficiaries of secured transaction reform and women-owned businesses benefit at even higher rates. In order to implement an effective collateralized lending system, states need functional secured transactions laws, an accessible collateral registry system, the political will to see the process through to fruition, and education to familiarize users and operators. Together with reforms such as reliable credit reporting, secured transactions reform helps micro and small entrepreneurs realize their full economic potential and bridge the gap to the formal economy.

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Introduction

Although micro, small, and medium enterprises (MSMEs) are engines of growth and provide positive social impact in Latin America and the Caribbean, they still face problems that limit their contribution to prosperity and growth. It is estimated that in the hemisphere MSMEs represent between 90 and 95 percent of registered companies but they only contribute, on average, to 40 percent of the GDP of countries in the region. More than a third of these companies, which represent between 50 and 70 percent of the jobs created, are headed by women, while about 25 percent are created by people under the age of 35.[2]

MSMEs often lack adequate access to finance. While micro-businesses have access to microloans and large businesses obtain loans from commercial banks at moderate rates of interest, small businesses are the missing middle. In Canada and the United States, small businesses use many different sorts of collateral – equipment, inventories, accounts receivable, warehouse receipts and intellectual property – as security for bank loans, whereas in most Latin American and Caribbean countries, financial institutions will not lend to any business owner who does not own real estate.

Access to collateralized loans from commercial banks through secured transactions reform (STR) allows MSMEs to compete in the modern economy by lowering their costs of borrowing. Lower operating costs should in turn lead to expansion and more employment. Allowing the use of non-real estate assets as collateral is also gender positive since women in developing countries tend not to possess title to real estate.

Bridging the gap from microfinance

More than 2.7 billion people in developing countries do not have access to basic formal financial services. In developing countries, about 400 million businesses lack the credit they need to grow. These enterprises typically employ fewer than 250 people, yet they account for nearly half the jobs created in the developing world. The World Bank estimates that the unmet financing needs of MSMEs total more than US$2 trillion.[3]

For nearly three decades, microfinance has been touted as a powerful development tool. Popularized by the Nobel Laureate Muhammad Yunus with the founding of the Grameen Bank in 1983, the microfinance industry has grown to

[2] Organization of American States Department of Economic Development, Trade and Tourism. "Promoting Economic Development in the Americas." Washington, DC: 2010.

[3] World Bank International Finance Corporation (IFC Advisory Services), *Access to Finance Annual Review 2011*, 4.

hundreds of institutions and millions of borrowers worldwide.[4] Microfinance institutions make loans without collateral but the amounts of the loans are small and interest rates can exceed 90 percent. By providing small, non-secured loans to people who are usually excluded from the banking system, microlending attempts to set the world's poor on the road to economic self-sufficiency.

But the past few years have exposed the weaknesses of microfinance. Microloans are expensive to administer and difficult to sustain in a commercially viable manner. For-profit microlenders are criticized for exploiting the poor while not-for-profit lenders are criticized for inefficiency and weak governance. Initial public offerings from Mexico's *Compartamos Banco* in 2007 and India's SKS Microfinance Ltd. in 2010 triggered heated debates about profiting from the poor. In 2010, the Indian state of Andhra Pradesh passed strict laws to regulate microfinance after a string of borrower suicides led to accusations of exploitation, harsh collection tactics and exorbitant interest rates.[5] (The controversy triggered more than $1.5 billion in microloan defaults in Andhra Pradesh. The Indian Central Bank has been tasked with damage control.)[6]

The Centre for the Study of Financial Innovation (CSFI) provides an annual report on the risks associated with microfinance. In 2012, the biggest microlending problems CFSI identified were over-indebtedness and institutional weaknesses that prevented lenders from adequately identifying and managing credit risks.[7] These problems are connected. In simple terms, borrowers are able to take more loans than they have the capacity to repay when lenders lack the capacity to assess the credit-worthiness of the borrowers or to effectively use collateral to secure the loans.

Youssef Fawaz, CEO of *Al Majmoua,* the leading nongovernmental microfinance organization in Lebanon explains: "We're noticing that clients ... drown themselves in debt by borrowing money from multiple institutions."[8] He blames the problem on rapid expansion of microcredit institutions, lack of regulation, and

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[4] Knowledge@Wharton (December 7, 2011), "Microfinance's Latest Challenge: Cutting Back on Over-indebtedness Among Its Poorest Clients," knowledge.wharton.upenn.edu/article.cfm?articleid=2895

[5] Madeleine Bunting (December 22, 2010), Microfinance: Development panacea, or exorbitant, ineffective poverty trap? *The Guardian*, http://www.guardian.co.uk/global-development/poverty-matters/2010/dec/22/microfinance-india-sector-regulated

[6] Knowledge@Wharton (July 26, 2012), "Rebuilding a Stronger Microfinance Sector in India," http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4696

[7] Centre for the Study of Financial Innovation, *Microfinance Banana Skins 2012: The CSFI Survey of Microfinance Risk, 2012: Staying Relevant* (July 2012), 7-8. www.csfi.org

[8] Knowledge@Wharton (December 7, 2011), "Microfinance's Latest Challenge: Cutting Back on Over-indebtedness Among Its Poorest Clients," knowledge.wharton.upenn.edu/article.cfm?articleid=2895

the absence of a strong credit bureau that would make it easier to identify clients who have multiple loans. "The information about whether clients have multiple loans or not is always hard to come by, so we have to guess," Fawaz adds. "Suddenly recipients cannot meet their repayment. This is how you uncover that this person has had two, three, four loans at the same time."

Over-indebtedness and institutional weakness are the leading problems of microfinance in Latin America as well. A bank auditor from Colombia argues that over-indebtedness is exacerbated by "increasing competition from new players and the policy of aggressive expansion of current competitors." A respondent from Peru states that microfinance governance problems are unavoidable "because the professionalism of the boards and the quality of management are not advancing at the same speed as the changes occurring in the industry." Without effective credit reporting, risk management and good governance, Latin American economies can expect continued deterioration of microlending results.[9]

Microlending is an instrument that has proven to work well for certain populations in certain circumstances but it is not a panacea for development or financial inclusion. Even when microlending works as it should, the problem of graduation from "micro" to "small" and from "informality" to "formality" persists. Under the conditions that prevail in most parts of Latin America and the Caribbean, an entrepreneur with a viable, growing business, collateral, and a proven ability to repay cannot move from microcredit to lower-interest bank loans unless she holds title to real estate.

The solution is not easy but it is clear: Put the responsibilities for lending in the hands of banking professionals who are already established in the community. Give them the tools they need -- through credit bureaus and transparent reporting mechanisms -- to adequately assess risk. Provide them with incentives to issue small, low-interest loans by reducing the transaction costs associated with such loans. Make it easy to check credit histories, register collateral and recover assets in the event of default and expand the range of assets that can be used for collateral.

Not coincidentally, this is a description of an effective secured transactions reform program. STR does not mean the end of microfinance, rather it is a way to strengthen microlending by providing a rational mechanism for micro-entrepreneurs to grow, prosper and eventually graduate from non-collateralized microloans. As micro firms expand and accumulate assets, they need access to the formal banking sector to obtain more affordable credit than can be provided by microfinance.

The importance of the formal credit market for MSMEs

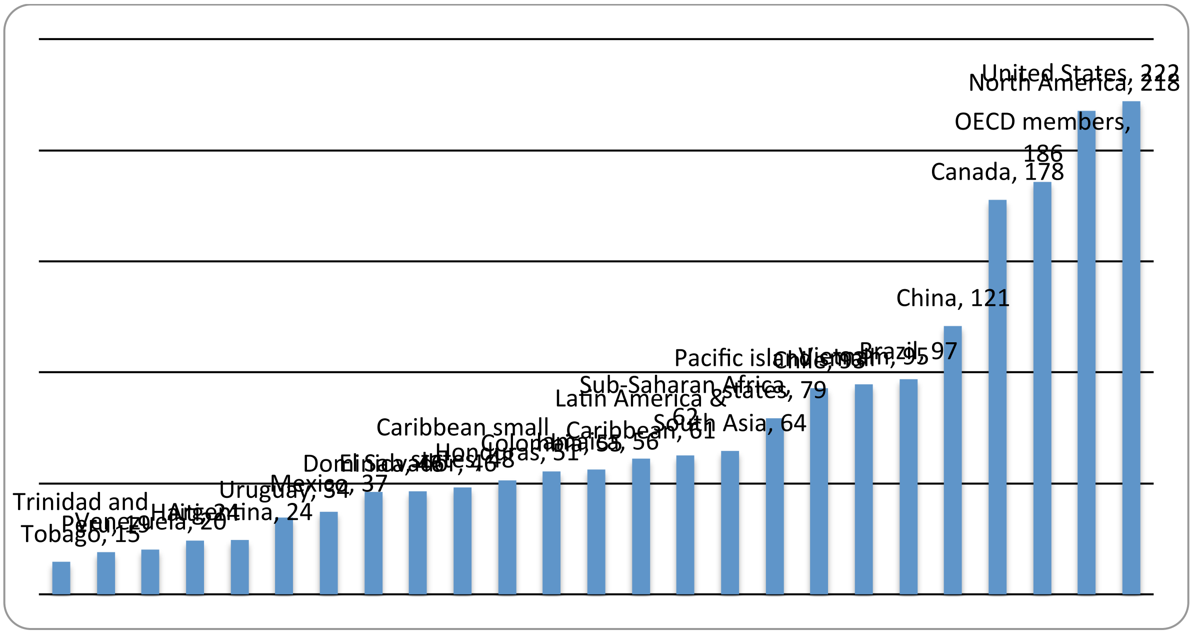
The U.S. sub-prime real estate crisis provides a sobering reminder that debt without the ability repay can cripple an economy. Conversely, where there are credit-

[9] CSFI, 15.

worthy entrepreneurs, credit is a catalyst for growth. All businesses need loans to buy equipment and stock, to hire more people, and to manage cash flow through cyclical fluctuations. If they cannot get credit from a formal banking institution, they will use informal means: family, friends and loan sharks who receive exorbitant interest rates.

The chart below illustrates the use of formal credit in various economies around the world. The illustration makes it clear those economies with higher incomes and sustainable growth patterns have higher rates of formal credit activity.

Domestic Credit Provided by the Banking Sector as % of GDP



Source: World Bank, 2008

Secured Transactions Reform provides access to credit for MSMEs

In a sound credit regime, lenders have confidence in the borrower's willingness and ability to repay the debt. Should the commitment not be honored, lenders are permitted to capture the assets that have been pledged as collateral. Efficient financial systems should allow the full range of assets to be used as collateral but in most countries in Latin America and the Caribbean, only real estate (immovable) assets can be used as collateral for bank loans. Since only a small percentage of small-business operators own real estate, the vast majority of MSMEs are unable to access bank loans at affordable interest rates.

Moveable assets such as machinery, inventory and accounts receivable typically represent over two thirds of a firm's capital stock. In countries with well-developed financial sectors, firms can use these assets as collateral for commercial loans. However, if land and real estate are the only accepted form of collateral, vast economic growth potential goes unrealized. Moreover, lack of recognition of moveable assets perpetuates economic inequality and inhibits upward mobility since only the wealthier sectors of society and large businesses can access credit at affordable interest rates.

Systems that allow both moveable and immoveable property to be pledged as collateral are often referred to as "secured transactions" regimes. Good secured transactions regimes provide a broad and flexible definition of what can serve as collateral; they provide clarity as to which creditors have priority in the event of default; and they allow for rapid enforcement of collateral agreements.

A **secured transaction** (*garantías mobiliarias* in Spanish, *sûretés mobilières* in French) is a loan or a credit transaction in which the lender acquires a security interest in collateral owned by the borrower. The lender is entitled to foreclose on or repossess the collateral in the event of the borrower's default. The terms of the relationship are governed by a contract or security agreement. The lender determines the value of the collateral and the claim is registered in a collateral registry system. The act of registration ensures that the borrower does not receive multiple loans for the same collateral.

STR By the Numbers[10]

78% The percentage of a business's capital stock that is held in moveable assets (machinery, equipment, crops) in a developing country.

75% The percentage of small business loan applications rejected for insufficient collateral in developing countries.

>60% The average interest rate for a microcredit loan in Mexico.[11]

<50% The percentage of small businesses in Latin America and the Caribbean that have access to credit from a financial institution.

40% The average interest rate small businesses pay for bank loans, when they are available, in Latin America and the Caribbean.

50% Interest rates for secured bank loans are on average 50 percent lower than microcredit loans.

<17% Fewer than 17 percent of small businesses in Latin America and the Caribbean use bank loans to finance investments.

12 In Jamaica there are twelve ways to register a bank loan but since only real estate and vehicles are accepted as collateral, the country has one of the lowest rates of formal credit use in the hemisphere.[12]

11 Repayment periods for secured loans are on average 11 percent longer than for microcredit loans.

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[10] All data in this section are estimates from the World Bank International Finance Corporation unless otherwise noted.

[11] Consultative Group to Assist the Poor (2008), "Why do interest rates vary so dramatically around the world?" *Microfinance Blog* http://microfinance.cgap.org/2008/06/20/why-do-microcredit-interest-rates-vary-so-dramatically-around-the-world/

[12] Keith Collister (July 1, 2012), "Why don't we just do it?" *Jamaica Observer.*

STR Basics

MSMEs in countries with stronger secured transactions laws and collateral registry systems have greater access to credit, better ratings of financial system stability, lower costs of credit, and fewer instances of non-performing loans.

Most industrialized economies have secured transactions laws but they have only been around for a couple of decades. Before that, the legal regime for small business borrowing resembled the patchwork of arrangements that apply in much of Latin America today. Article 9 of the United States Uniform Commercial Code and Canada's Personal Property Securities Acts serve as templates for many of the laws adopted around the world. Modern secured transactions laws are adaptable to both common and civil law traditions.[13] The reform process is focused on three core areas:

1. Reform of the banking laws,
2. Establishment of a transparent collateral registry system and
3. Regulatory changes to allow creditors to seize pledged assets in the case of defaults

Reforming the banking laws allows borrowers and lenders to recognize moveable assets as collateral. Such assets include: vehicles, equipment, inventory, raw materials, accounts receivable, secured sales contracts, crops, livestock, minerals, timber, bank accounts, insurance policies, durable consumer goods, and intellectual property. The risk of lending is reduced when a creditor can claim an interest in the moveable assets of a borrower. Lower-risk lending for banks means lower interest rates for borrowers.

The collateral registry system is key to reducing the cost of borrowing. Traditional registries involve fees paid to notary publics and paper-based registrations at government offices. Searches are expensive and time-consuming. New forms of electronic collateral registration are online, secure, and accessible even from remote communities. Information gathering conforms to international standards.[14] Most importantly, the information is centralized and up-to-date. This prevents borrowers from obtaining multiple loans for the same collateral.

Finally, in the event of default, creditors need a simple process to have their claim legally recognized and to repossess the pledged capital, preferably without the complexity of court orders and sheriffs. (See the Pacific Islands case study in Annex 1.) The 2012 World Banks *Ease of Doing Business* report notes that when lenders

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[13] World Bank IFC (2010), *Secured Transactions Systems and Collateral Registries,* p. 31.

[14] See Alejandro Alvarez de la Campa, Santiago Croce Downes, and Bettina Tirelli Hennig (2012), "Making Security Interests Public: Registration Mechanisms in 35 Jurisdictions," World Bank IFC.

have better legal protection in cases of default, they become more confident about the return of their investment and therefore more willing to extend credit on favorable terms.[15]

Secured transactions reform works best within a broader framework of financial inclusion measures that include an on-line payments system to provide safe and efficient transfers of funds between buyers and sellers and credit bureaus.[16]

Credit bureaus serve to establish and codify individual credit ratings. Improved credit reporting -- positive as well as negative reporting -- helps banking systems to function more effectively and expand borrowing opportunities for individuals. When the creditworthiness of the business owner has been established, a secured business loan can be provided with greater confidence. Moreover, once citizens are comfortable with the concept of a central registry for individual credit history, the next step of a central database for loans and collateral is more readily accepted.

The benefits of STR for women entrepreneurs and under-served groups

One of the defining features of microfinance organizations has been their outreach to women. The UN reports that in 2007 microfinance organizations reached 154.8 million clients, of whom 106.6 million were among the poorest population demographic when they took their first loan. Some 80 million of these borrowers were women.[17]

The majority of microenterprises are women-owned. Studies of women entrepreneurs in India and Colombia show that women borrowers are more likely than their male counterparts to use credit to expand the size of their enterprises, make business improvements and hire more workers.[18] In order to help women grow beyond the micro stage, it is essential to ensure that the financial system

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[15] World Bank (October 2011), "Getting Credit," *Doing Business 2012: Doing Business in a More Transparent World*, Chapter 2. http://www.doingbusiness.org/reports/global-reports/doing-business-2012/~/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB12-Chapters/Getting-Credit.pdf

[16] World Bank IFC, *Caribbean Panorama,* Vol. VII (February 2011).

[17] United Nations Department of Economic and Social Affairs Division for the Advancement of Women, (2009*) World Survey on the Role of Women in Development: Women's Control Over Economic Resources and Access to Financial Resources, Including Microfinance* (ST/ESA/326), 57.

[18] Women's World Banking /Accenture (2009), "The Impact of Microfinance on Women and Economic Development: A Client Study," http://www.swwb.org/sites/default/files/pubs/en/impact_of_microfinance_on_women_a_client_study_e.pdf

provides women with continuum of credit access. Charles Shapiro, former head of the U.S. State Department Financial Inclusion Working Group, reports that some women-owned businesses in Latin America are forced to cobble together 60 or 70 short-term microloans a year because, owning no real estate, they cannot get bank loans.[19] The extra burden of juggling microloans robs women of time they need for their businesses and their families.

Improving women's access to credit is sound economics but it is also sound social and political development. According to Women's World Banking, women entrepreneurs invest a higher percentage of their income into enhancing their family's financial security, access to health care, education and housing. [20]

This paper has argued in favor of expanding the capacity of the formal banking sector to provide sustainable small-business financing to entrepreneurs rather than investing NGOs with banking responsibilities. At the same time, it is important to recognize that changes to banking laws are not sufficient to encourage the formal banking sector to change its engagement with women entrepreneurs and the poor. According to the UN, microfinance organizations have been successful in reaching poor women because, in addition to loans, they specifically addressed the constraints women face and provided social and educational supports.[21]

When considering alternatives for the future we should consider financial inclusion initiatives that incorporate lessons learned from NGO-based microfinance. For example, Peru's *Pro Mujer* operates an integrated credit and microenterprise training program and also offers health and family planning services*. Crédito con Educación Rural* (CRECER), the largest group-based lender in the Bolivia, offers integrated health education and microfinance services through weekly meetings with village banking associations.[22] These examples suggest an opportunity for development partnerships between NGOs and commercial lenders so that both entities can do what they do best.

Bridging the gap between informality and formality

Studies show that the type of credit extended to MSMEs matters**.** Formal credit is better than informal because it has an impact on business performance that is two to three times the impact of informal credit in terms of increasing profits and firm

[19] Charles Shapiro (June 27, 2011) "Remarks at the Diplomacy Briefing Series on U.S. Policy in the Caribbean," State Department Bureau of Western Hemisphere Affairs, http://www.state.gov/p/wha/rls/rm/2011/167447.htm

[20] Women's World Banking /Accenture (2009).

[21] UN, p. 64.

[22] UN, p. 59.

survival rates.[23] In a 2006 study of Mexican micro-firms, access to formal credit was identified as the most important factor in helping firms grow to the size dictated by their intrinsic entrepreneurial ability.[24] MSMEs across the hemisphere are trapped in a suboptimal situation. Because they lack access to formal credit, they cannot grow, create jobs, and reach their full potential.

Informality is linked to low investment, free riding (overuse of public goods, low tax collection), unfair competition, low innovation, high vulnerability to income shocks, inadequate health and safety protection for workers, and vulnerability to extortion because of lack of legal status.[25] Barriers to entering the formal economy include expensive and time-consuming registration processes and difficulties proving ownership.[26] Moreover, there are disincentives to formalization, including a litany of taxes and fees with no guarantee of reciprocal benefits and vulnerability to extortion by corrupt officials. A report on the informal economy from Sweden's international development agency observes, "Small-scale entrepreneurs make an economic calculation along the lines of a cost-benefit analysis, which determines a minimum threshold of participation in formal arrangements for which the cost remain lower than the benefits."[27]

Since business registration is a pre-requisite for a bank loan, access to affordable credit helps to improve the incentives for a business to enter the formal economy. Formal businesses pay taxes and are invested in the social, political and economic stability of their communities and their states. They serve as a source of information regarding business activity to help governments plan effective commercial and economic policies.

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[23] Pablo Fajnzyylber, William F. Maloney, and Gabriel V. Montes Rojas (2006), "Releasing Constraints to Growth or Pushing on a String? The Impact of Credit, Training, Business Associations and Taxes on the Performance of Mexican Micro-Firms," *World Bank Policy Research Working Paper* 3807, p. 1

[24] Fajnzyylber et al., p. 17.

[25] Ana Maria Oviedo, Mark R. Thomas, Kamer Karakurum-Özdemir (2009), "Economic Informality: Causes, Costs, and Policies, "*World Bank Working Paper* No. 167.

[26] See Hernando de Soto (1989), *The Other Path: The Invisible Revolution in the Third World*. HarperCollins.

[27] Marsha Floodman Becker (March 2004), *The Informal Economy*, Swedish International Development Cooperation Agency (SIDCA), p. 24.

Access to credit in the Americas

Economies in the Americas have made some strong efforts at secured transaction reform but more needs to be done. [28] The National Law Center for Inter-American Free Trade has been tracking STR progress on a national level in the Americas. NLCIFT reports that, as of July 2012, only Canada, the United States and Honduras had fully implemented a comprehensive STR system. Chile, Guatemala, Mexico, and Peru have all made good progress but more reforms are necessary. The remaining states have significant work to do.[29]

Success Stories

Honduras

In March 2011, Honduras enacted a new secured transactions law and launched a new collateral registry. During the first four months of operation there were 1,689 filings. Most filings relate to vehicles but 19 percent involve commercial assets such as accounts receivable, retail and wholesale inventories, and agricultural, commercial, professional and industrial equipment. The low value of some of these collateral assets suggests growth in secured credit for micro and small businesses. [30]

Mexico

Over the past ten years, Mexico has been making successive improvements to its collateralized lending regime. The *Law on Negotiable Instruments and Credit Operations* was amended in 2003 to introduce modern types of security interests and a nationwide registry for movable collateral was created in October 2010. In the first six months of operation, Mexico's *Registro Unico de Garantías* had triple the number of filings compared with the same period before the reform.[31] Between October 2010 and July 2012, Mexico made over 74,129 collateral registrations for a total secured amount of over US$190 billion.[32]

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[28] According to the *Ease of Doing Business Report* 2012, Sub-Saharan Africa and Eastern Europe have made the most intensive efforts at reforming lending laws and establishing collateral registry systems in recent years.

[29] Institute of the Americas maintains this information on a secured transactions database. See http://www.iamericas.org/STR/documents/Matrix_ST_Western_Hemisphere_2012.pdf and http://iamericas.org/STR/documents/Matrix_ST_Country_Assessments_2012.pdf

[30] World Bank (October 2011), "Getting Credit," *Ease of Doing Business Report.*

[31] World Bank (October 2011), "Getting Credit," *Ease of Doing Business Report.*

[32] World Bank IFC, (August 10, 2012), Press Release: "IFC Results Drive Secured Transaction Reforms Across Latin America," http://www1.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/industries/financial+markets/news/ifc+results+drive+secured+transaction+reforms+across+latin+america

The Role of Donors

In order to facilitate reforms and to align the Americas with international best practices, the Organization of American States introduced the Inter-American Model Law on Secured Transactions in 2002 and Model Registry Regulations in 2009. Honduras, Guatemala, and Mexico have adopted (fully or in part) reforms based on the model law. Momentum is continuing in Chile, Colombia, Costa Rica, El Salvador, Haiti, Jamaica and Panama.

In addition to the OAS work on model laws, the World Bank Group's International Finance Corporation has taken the lead in providing technical assistance for reforms in Latin America and around the world. In the late 1990s and early 2000s, the Multilateral Investment Fund of the Inter-American Development Bank financed STR initiatives in Jamaica, Haiti, Guyana and Trinidad and Tobago.

Financial inclusion is cited as a priority a by national donors such as USAID and the Canadian International Development Agency (CIDA), but STR has not been a priority area of program focus. Private sector banks and commercial finance associations are taking an increasing role in supporting reforms to promote collateralized lending in the hemisphere. Elsewhere in the world, the Asian Development Bank and the European Bank for Reconstruction and Development have financed comprehensive STR efforts.

What we need to do differently

With such clear benefits, it is surprising that collateralized lending for MSMEs has not been universally adopted. Slow or incomplete uptake for STR stems from three related challenges. First, the legal reforms are fairly technical and take place out of the public eye so it is hard to provide tangible evidence of progress to stakeholders. The most likely place for a secured transactions reform initiative to fail is in the stage between legal drafting and legislative approval.[33]

Second, reforms involve dismantling the status quo and reducing rents to those who benefit from the existing system. They are quite likely to attempt to block the change.[34]

Third, potential MSME beneficiaries are unlikely to fully comprehend the magnitude of the benefits that STR could provide for them. Therefore, they are not

[33] Author's interviews with STR technical assistance providers in Vietnam, Albania, Jamaica and Trinidad and Tobago.

[34] In many civil law jurisdictions, for example, notary publics charge a percentage of every loan they register – expensive for borrowers but lucrative for notaries.

likely to be much help in mobilizing the political will necessary to see the reform process through to completion.

The World Bank identifies insufficient domestic support -- the lack of a local champion -- as the number one risk to STR success. "If the local champion is not convinced of the reform's value and does not support it 100 percent, the overall success of the project will be at risk.... It would be better to drop the project than to proceed without support. "[35] Local champions include business groups, banking associations, Chambers of Commerce, banks and non-band financial institutions, Central Banks, and Ministries of Finance, Justice and Trade. More needs to be done to link up the back-room technical reforms taking place at Ministries of Justice with information, outreach, and consensus building with MSME stakeholders and the bankers who will benefit from being able to offer secured loans to a larger pool of borrowers.

Technical assistance programs demand more than just training a small cadre of legal and banking experts in international norms. Rather there is a need to deeply integrate understanding of the importance of reform among a wide community of government officials, political figures, business leaders, SMEs, NGOs and other opinion leaders in the community.

It is important to remember that these reforms are targeting MSMEs, a sector that is currently underrepresented in the formal banking sector. Business opinion leaders are typically drawn from large, successful firms, and these firms tend to have highly satisfactory relationships with their banks. They are not the kind of businesses most directly helped by secured transactions reforms. The main STR beneficiaries are small businesses, women-led firms, youth, and entrepreneurs in remote communities – all of whom lack voice and presence in commercial policy making spheres. Thus political consensus building must be combined with outreach and education efforts aimed at those outside the mainstream.

Reforms are also impeded by the conservatism of the banking sector and reluctance to change. For example, good secured transactions systems depend on transparent registry of claims against assets but there is significant concern among the business community that such systems threaten commercial confidentiality, especially in smaller economies. Therefore, it is important that the collateral registry systems – even though they must meet international standards – are also adapted to local conditions.

[35] World Bank IFC, *Secured Transactions and Collateral Registries* (January 2010), p. 29.

Actions for the Future

Outreach, education, and local ownership are key to effective implementation. Some specific steps to achieving these goals are:

1) Ensure that outreach and education are appropriate to the needs and experiences of MSMEs.
2) Build MSME capacity by matching up commercial lenders with NGOs in cooperative projects that provide both sustainable financial governance and social, health and education supports.
3) Build upon lessons learned and best practices from other jurisdictions in the hemisphere. The IFC, Institute of the Americas, and NLCFIT offer information resources and databases but more needs to be done, especially in the area of training activities, study tours and field trips to see STR in action.
4) Conduct further research into effective methods of consensus building and domestic implementation including examining timing of reforms and effectiveness of national champions. This will help us to see reforms through to successful implementation.
5) Conduct further research into the results of STR on MSMEs, including types of collateral, recipients, loan sizes, etc., so that we can better focus reform efforts and better understand prospects for MSME growth and graduation to the formal sector. This research will help us prove a more compelling picture of why STR works for those considering reforms.

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Annex 1: Secured Transactions Reform in the Pacific Islands

In 2006, the Pacific states of Marshall Islands, Micronesia, Palau, Papua New Guinea, Solomon Islands, Samoa and Vanuatu introduced a program of secured transactions reforms. By 2012, most of these reforms were in place, providing marked improvements for borrowers, particularly small businesses, women and marginalized groups.

The pre-existing legal system made it very difficult to pledge moveable collateral. Loans against accounts receivable were unheard of. The communal and traditional land tenure system common in many of the Pacific Islands made it impossible for most people to pledge land as collateral.

The costs of borrowing were high because every loan agreement had to be drawn up by a lawyer. Without a collateral registry system, it was difficult for lenders to determine if assets being pledged had already been used as collateral with another lender. Searches required an in-person visit by the lawyer to the companies' office or the bills-of-sale registry where record keeping was "frequently chaotic." Borrowing was extremely expensive once legal costs and transaction fees were factored into effective interests rates. Repossession in the event of default required a court order and could only be undertaken by a sheriff, who was often unavailable. Pre-STR, credit conditions were risky for lenders and expensive for borrowers. As a result, formal bank loans were not a viable option for small businesses seeking small, short-term loans to expand their businesses or manage cash-flow volatility.

The Pacific Islands reforms involved updating bank laws, some dating back to the 19th century, and the implementation of modern Personal Property Securities Acts, modeled on the New Zealand laws.[36] Lenders now register all pledges of collateral on an easily searchable electronic registry. Transaction costs are reduced through the use of standardized loan documents and elimination of the stamp duty. Instead of an annual duty, a small flat fee is charged for collateral registration. In the event of default, lenders do not need to obtain court orders and can repossess the assets themselves, reducing transaction costs and lending risks.

By making it possible to make small, inexpensive loans against moveable assets, small businesses now find it easier purchase equipment such as boats, outboard motors, rotor tillers, and trucks because equipment dealers and finance companies can easily secure these assets as collateral.

Credit Corporation, the leading nonbank financial institution in Solomon Islands, reports that the amount of time spent approving a loan has been reduced from 30 days to a single day through simplified agreements and the elimination of the need

[36] New Zealand's Personal Property Security Act was modeled on the 1989 and 1993 Personal Property Security Acts created for the Canadian province of Saskatchewan. See http://esask.uregina.ca/entry/personal_property_security_act.html

for government approvals. It also found that the simplified enforcement mechanism has made a significant difference, rendering repossession cheaper and faster. Credit Corporation has significantly increased the number of loans it issues, particularly to under-represented borrowers in remote areas and women entrepreneurs.

Once the framework has been fully institutionalized, the Asian Development Bank expects that offshore lenders will enter the Pacific Islands financial market, making use of new, transparent procedures for the registration of security interests, thereby increasing the pool of credit available to borrowers and decreasing the cost.

In terms of lessons learned from the Pacific Islands experience, the ADB notes that simply passing a law will not bring about the desired results. Intensive implementation is also needed together with education and capacity building for the operators of the electronic registry, for lenders and the legal profession.

Source: Asian Development Bank, Pacific Economic Monitor, July 2012 http://www.adb.org/publications/pacific-economic-monitor-july-2012