This article emphasises the economic significance of modern access to finance legal systems. It also aims to understand how the Bank’s experience in supporting access to finance reforms in eastern Europe and central Asia can be of relevance in the southern and eastern Mediterranean region.
Over 20 years ago, none of the EBRD’s countries of operations had developed the infrastructure enabling market-based access to finance to companies or individuals. As the introduction of the concept of “market economy” was under way, financial products such as secured lending, financial leasing, factoring and housing finance were almost non-existent. The legal regimes that would have allowed such products lacked most of the rules that would enable market participants to engage in financial transactions with a minimum required level of legal certainty and market efficiency.

The EBRD’s Secured Transactions Project was thus established in 1992 to assist with the legal reform related to secured transactions. Over the years, the Bank’s Legal Transition Programme (LTP) expanded to other areas such as collateral registries, credit bureaus, financial leasing and agricultural financing, in addition to separate areas of the law, such as corporate governance, insolvency, infrastructure regulation and energy efficiency.

It is striking that a fairly recent publication by the World Bank on Financial Access in the Middle East and North Africa region pointed to the financial infrastructure in general, and creditors’ rights more specifically, as a major stumbling block to the region’s broadening and deepening of access to finance. With economic reforms as a cornerstone of the demands expressed during the so-called “Arab spring”, it is believed that the time has come to tackle those issues.

The purpose of this article is to understand how the EBRD’s experience in supporting access to finance reforms in its traditional countries of operations, eastern Europe and central Asia (EECA) can be of relevance in the EBRD’s new region – the southern and eastern Mediterranean (SEMED).
A totally different starting point

While the legal provisions allowing access to finance in the EECA countries were almost non-existent at the beginning of their transition process, the situation in SEMED is very different. A cursory overview shows that all SEMED countries’ legal regimes provide for techniques such as leasing, housing finance and mortgage law, non-possessory security rights over movable assets, and credit information reporting systems. This does not, however, mean that there is no need for reform in SEMED but that the approach to reform cannot be inspired by the early EECA transition experience. Both the openness of countries to engage in legal reforms (very high in the early EECA transition) and the existing legal systems (rudimentary in EECA) provide a very different starting point.

While the approach to reform itself may not be inspired by the early EECA transition experience, it seems very apposite to take inspiration from lessons drawn from the different experiences of EECA countries in relation to reform, bearing in mind that reform in itself did not always yield the results that might have been foreseen. As will be presented below, some legal frameworks that have undergone reform, actually display overly complex legal provisions, often based on obsolete concepts and even contradictory principles. The complexity of legal rules can perhaps create in the minds of the economic players a false impression of sophistication. This can compound the difficulty of recognising the need for improvements. Also, a developed and complex system, albeit inefficient, would necessitate a very tailor-made analysis of how best to proceed with reform since changes would in all likelihood disturb the existing equilibrium (however deficient to the overall economy) among the economic stakeholders.

EBRD assessment – focusing on economic objectives

In the course of its work on secured transactions, the Bank has formulated ten core principles for a secured transactions law, which provide broad directions for reform. These principles are set out in the table below.

EBRD 10 core principles for a secured transactions law

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<tr>
<td>1.</td>
<td>Reduce risk of credit&lt;br&gt;Security should reduce the risk of giving credit, leading to an increased availability of credit on improved terms.</td>
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<td>2.</td>
<td>Non-possessory security, easy and cheap to create&lt;br&gt;The law should enable the quick, cheap and simple creation of a proprietary security right, without depriving the person giving the security of the use of his assets.</td>
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<td>3.</td>
<td>Satisfaction through realisation in case of default&lt;br&gt;If the secured debt is not paid, the holder of security should be able to have the charged assets realised and to have the proceeds applied towards satisfaction of his claim, prior to other creditors.</td>
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<td>4.</td>
<td>Effective enforcement&lt;br&gt;Enforcement procedures should enable prompt realisation at market value of the assets given as security.</td>
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<td>5.</td>
<td>Effective in insolvency&lt;br&gt;The security right should continue to be effective and enforceable after the bankruptcy or insolvency of the person who has given it.</td>
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<td>6.</td>
<td>Low cost&lt;br&gt;The cost of taking, maintaining and enforcing security should be low.</td>
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<td>7.</td>
<td>All types of assets/debts/persons&lt;br&gt;Security should be available&lt;br&gt;• over all types of assets,&lt;br&gt;• to secure all types of debts and&lt;br&gt;• between all types of persons.</td>
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<td>8.</td>
<td>Publicity&lt;br&gt;There should be an effective means of publicising the existence of security rights.</td>
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<td>9.</td>
<td>Priority&lt;br&gt;The law should establish rules governing competing rights of persons holding security and other persons claiming rights in the assets given as security.</td>
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<td>10.</td>
<td>Commercial flexibility&lt;br&gt;As far as possible the parties should be able to adapt security to the needs of their particular transaction.</td>
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If the legal framework for secured transactions is to operate in a way which maximises economic benefit, the system for creation and enforcement of pledges should be simple, fast and inexpensive.

These core principles do not seek to impose any particular solution on a country as there may be many ways of arriving at a particular result. The core principles do however seek to indicate the result that should be achieved from an economic standpoint. In order to assess whether the particular route chosen by a given country has achieved its objectives, the EBRD focuses on the concept of legal efficiency, that is to say, the extent to which a law and the way it is used provides the benefits that it was intended to achieve.

While recognising that it may also have important social functions and consequences, the prime purpose of a secured transactions law is economic, since the secured credit market has essentially an economic function. A secured transactions law should thus be essentially facilitative since a secured credit market is not a necessity, it being theoretically possible for any jurisdiction to function without it. We work on the premise that the basic legal framework should be conducive to a flexible market for secured credit. There are also social issues, for example relating to consumer credit and economic issues, such as risk management, but the driving force behind the introduction of a law on secured transactions is the benefits that such a law is expected to bring to the economy.

A relatively simple indicator of the success of a secured transactions law reform (or primary motive for undertaking the secured transactions law reform) would be the subsequent increase in the volume of secured lending. This is a crude and narrow indicator, inadequate by itself. The intended function of the secured credit market may be more than just to boost the amount of credit granted against security. It may also include, for example, opening up credit to new sectors of society, encouraging new housing construction, or allowing privately funded infrastructure projects.

The intended function of a law has to be looked at in the context within which it is to operate. Its ramifications have to be considered not just in economic terms but in social and cultural terms as well. Thus an appropriate balance has to be struck between fulfilling the law’s economic purpose and ensuring that the effects of the law are acceptable in context.

The EBRD has thus designed a set of criteria evidencing the legal efficiency of a secured transactions legal regime by looking at the degree to which the legal framework enables secured transactions first, to achieve their basic legal function (further discussed below) and secondly, to operate in a way which maximises economic benefit – which is itself broken into five separate headings: simplicity, cost, speed, certainty and fit-to-context.

The basic legal function of a secured transactions law is to allow the creation of a security right over assets which, in the case of non-payment of a debt, entitles the creditor to have the assets realised and the proceeds applied towards satisfaction of his/her claim prior to claims of unsecured creditors, based on a predictable priority order among secured creditors. If a secured transactions law only gives the creditor a personal right against the debtor but no right in the assets, or if there is no right to enforcement or priority regarding other creditors, the law fails to achieve its basic legal function. An absolute priority for taxes and other state claims ranking above the secured creditor, or the right in insolvency of ordinary creditors to share in a portion of the proceeds of secured assets are more than mere inefficiencies in the secured transactions law; they are defects which prevent it from fully achieving its basic function. They may be intentionally created (a super-priority of the state usually is) but they reflect a compromise between two laws with conflicting purposes.

If the legal framework for secured transactions is to operate in a way which maximises economic benefit, the system for creation and enforcement of pledges should be simple, fast and inexpensive. There should also be certainty as to what the law is and how it is applied, and it should function in a manner which fits the local context.

The advantage of such an assessment approach is that it enables the EBRD and others to undertake a review of a legal framework dispassionately, with the view of identifying objectively areas of strength and areas of weakness, as opposed to applying a rigid approach where a system would a priori qualify as weak because it does not fit formal expectations of what the law should look like; or conversely as strong because in theory it ticks all the boxes but fails to work properly in practice.
When the market calls for reform

Turning back now to the SEMED region, preliminary enquiries show that lenders (mostly banks) favour greatly, if not exclusively, land and buildings as assets, which can serve as collateral. Land and buildings have of course always been seen as the most valuable and reliable form of collateral – primarily because they are immovable and thus less subject to dissipation as well as tending to have a more stable market value. However, secured lending that would rely exclusively on land and buildings would be extremely limited since many businesses and individuals do not necessarily own or have sufficient land or buildings available to provide as security. Moreover, modern finance has permitted the turning of intangible assets such as accounts receivable, stock and shares, bank accounts, and other assets, into collateral. Therefore a modern, economically sound legal system must allow the use of other types of assets, such as inventory, stock or bank accounts, as valuable collateral, including future property.

The legal system that would be tailored on the modern approach of legislating non-possessory security rights over any type of movable property does not currently exist in any of the SEMED countries. Besides the principle of possessory pledges, limited exceptions have been created by statutes with regard to specific assets. One of the most commonly used is the pledge/mortgage over a fonds de commerce.3

Fonds de commerce is a legal concept originally developed under French Law, which primarily targets the intangible assets that constitute a business – the commercial name, goodwill, leasing contracts, but also in some cases equipment and stock of goods. These elements can collectively be pledged to creditors on a non-possessory basis subject to registration.

For instance, the Egyptian fonds de commerce mortgage has a defined scope over the assets it can include.4 Moreover, the assets need to be specifically designated into the pledge agreement. This means that future assets, such as equipment that the business may acquire in the future, would not automatically be included in the fonds de commerce mortgage. Furthermore, the type of mortgage creditors that can take a fonds de commerce mortgage is limited by law to banks and other financial institutions. This excludes trade creditors (for example, wholesalers) and other non-financial institutions from using this type of security when extending trade credit which can have a negative effect on the availability or price of such finance.

Evidence for the need for reform is usually found when market practices develop, which circumvent certain rules. These practices can achieve the intended result but such a result tends to come with a high dose of legal risk and/or high transactions costs. For example, it seems that banks in Egypt engaged in SME finance find that the most relevant security instrument (Fonds de Commerce mortgage) is too cumbersome (many of the assets that would be included in the mortgage are not sought after by the bank and/or the borrower may not be prepared to grant the bank a security over them as the value would be disproportionate to the secured debt) and/or too costly (the mortgage requires notarisation of the agreement and registration at the competent Commercial Register).3 Therefore, banks have in some instances reverted to the taking of a possessory pledge as governed by the Civil Code over the assets they are willing to accept as collateral but would include in the pledge agreement the provision that the transfer of possession would be made to the manager of the debtor company acting as a third party for the interest of the bank (custodian). This may be a well-accepted practice; however, one could say that it would be legally much more coherent to instead recognise the concept of non-possessory pledge over assets which would be defined as the parties deem fit, and to review the conditions of validity of the security agreement in order to keep transaction costs low.

A well-functioning modern secured transactions legal framework should reflect some basic principles which have proven to facilitate successfully access to finance. It should (i) enable a wide range of entities and individuals to use a broad scope of permissible collateral which includes a future and fluctuating pool of assets, (ii) allow a high degree of flexibility in describing the secured debt (securing overdraft facilities), and (iii) embrace clear priority rules and efficient solutions of enforcement of secured creditors’ rights. Legal rules should be clear and precise leaving no room for contradictory interpretations while allowing
If and when the local stakeholders in any of the southern and eastern Mediterranean countries decide to embark on the journey of legal reform, they will first be faced with a hard choice: a general overhaul of the system or amending and fine tuning the existing legal framework.

the parties the freedom to tailor the security package to their needs. As already presented, legal systems that underpin lending against movable assets in the SEMED region do not reflect well these principles and there is therefore a real market need for reform.

Starting all over or piecemeal reform?

If and when the local stakeholders in any of the SEMED countries decide to embark on the exciting but demanding journey of legal reform, they will first be faced with a hard choice.

On the one hand, they could decide to undertake a general overhaul of the system. This would consist of repealing all legal provisions on security over movable property and potentially other transactions serving as security (such as financial leasing) and adopting a new single law. The advantage of this approach is that it creates coherence in the system and users would have all relevant provisions under one law. However, this approach is a time consuming major undertaking, especially since the market players (as mentioned above) have already developed an extensive practice of the system and may therefore not welcome the costs associated with radical changes. A good example of a developed jurisdiction caught up in a similar debate for the last decade is England and Wales where the law allows for a multiplicity of different security interests. While most legal practitioners agree that some aspects of the system do not function well or would benefit from simplification, there has also been resistance to the costs that such a wide-ranging reform would entail.

On the other hand, local stakeholders in the SEMED countries might prefer amending and fine tuning the existing legal framework. This is usually more appealing as it appears to be a simpler exercise and does not require a drastic departure from existing tradition and practices. However this comes at a price that may be less obvious initially. Amendments would not necessarily bring about the same level of clarity that an overall reform would and the final framework could end up being very complex and include contradictions and loopholes. Further, amendments may also entail the market failing to grasp the opportunities brought about by change, which would result in de facto no results at all, all parties remaining in their initial positions.

The EECA region provides a good example of both approaches – an almost perfect
The main reason for taking a complicated route of legal development in this area was probably due to the perception that it is impossible to touch the “sacred cow” that the Property Act represents.

A comparative experiment in two countries that shared a similar legal heritage: Croatia and Serbia, both former republics of the Socialist Federal Republic of Yugoslavia.

After initial reform of the Yugoslav 1980 Basic Proprietary Relations Act, which was carried out after Croatia’s independence, Croatia opted for a gradual fine tuning approach of its secured transactions system. Faced with the lack of flexibility of the provisions of the newly introduced Property Act, lawyers, in a rather ingenious interpretation of the provisions, started using the enforcement law to create security.

One procedure provided in the Enforcement Act allows to freeze debtor’s assets in favour of a creditor. The advantage of such legal fiction is that the creditor is in a very strong position to enforce its security over the assets, should the debtor default. The downside, on the other hand, is that such an approach can only apply to existing assets and also it would not be possible for another creditor to take security over the same assets (ranking second, as a “classic” secured transactions law permits). In addition, the Enforcement Act introduced the concept of a fiduciary transfer of ownership for security purpose over immovable and movable property and rights and allowed the parties to execute such contracts in the form of a contractual enforcement writ, thereby avoiding the need to obtain a court decision before proceeding with a judicial sale of the collateral.

It has to be noted that although the Enforcement Act was amended more than a dozen times since its introduction in 1996, the practice of using some of its provisions as a basis for creating security rights has survived and was even confirmed by the legislators in 2005 when the Act on Registry of Pledge over Movable Property was introduced to establish a register of non-possessory security and fiduciary transfer of ownership created according to the Enforcement Act. In addition to establishing the register, and probably as a result of the legal gap the previous developments have failed to fill, the Act also introduced, in its final and transitory provisions, a new type of collateral, a floating charge over movable property which applies to a fluctuating pool of any movable assets (described generically in the pledge agreement) which are linked to the specifically designated space, thus adding to the already terribly fragmented regulation of security rights.
The financing of farmers, agricultural companies or importers of agricultural products is often challenging for banks and other financial institutions because of their limited ability to provide valuable collateral.

The main reason for taking such a complicated route of legal development in this area was probably due to the perception that it is impossible to touch the “sacred cow” that the Property Act represents. Instead, the lawmaker took the seemingly easier path and built on the practice of taking security using the procedures provided in the Enforcement Act. De facto regulating secured transactions as part of the Enforcement law, apart from being conceptually wrong, has naturally created legal uncertainty and made transaction costs much higher than necessary. For example, since the security agreement is in essence part of a voluntary enforcement process, it has to be notarised, thereby increasing costs. Up until the recent changes to the Act, it used to cause a voluntary freezing of the underlying assets in favour of the creditor (raising questions on the practicability and legality of taking security over revolving intangible assets such as accounts receivable).

Serbia, on the other hand, took a totally different approach by opting for a unified and coherent approach to reform. With the support of the EBRD, Serbia repealed provisions on pledge which existed in the Yugoslav 1980 Basic Proprietary Relations Act &d and enacted in 2003, the Law on Registered Charges on Movable Assets which introduced a simple, clear and efficient means of pledging and registering movable property and rights. The adoption of the Law was followed by the creation of the Register of Pledges on Movable Property and Rights kept by the Business Registers Agency. The consequence of such a comprehensive and coherent approach was an increased legal certainty and wider accessibility to asset-based finance due to simple creation, registration and enforcement procedures provided in the Law.

Of course, all countries are unique and each reform follows its own economic and political path. However, we believe that some important lessons can be learned from examining the choice made by other countries, and the related outcomes.

Creating new instruments

Reforming the fundamentals of secured credit is often only one step towards unleashing the potential of diverse financing instruments serving all segments of the economy. Specific market products have to be tailor-made for a specific sector, and the agricultural sector is a good case in point where the EBRD has been called to play a key role in the EECA region, and is hoping to share such experience in the SEMED region.

In September 2012 the Food and Agriculture Organization of the United Nations (FAO) and the EBRD organised a large regional Conference on “Private Sector for Food Security” in Istanbul. This forum enabled agricultural private and public stakeholders in the EECA and SEMED region is to meet and discuss their concerns and ongoing projects. The positive experience of the East-Agri platform in promoting different models of financing and the development and maximizing of the efficiency of food chains were discussed. As a co-founder of the East-Agri platform the EBRD has been providing technical assistance in setting up and investing in modern warehouse receipts systems facilitating commodity finance and access to finance by farmers.

The financing of farmers, agricultural companies or importers of agricultural products is often challenging for banks and other financial institutions because of their limited ability to provide valuable collateral. Inspired by the US experience of the 19th century, a modern grain warehouse receipt system can help these borrowers to access finance. Broadly speaking, the system is based on storage of commodities into a warehouse where the warehouse operator issues a receipt on delivery of the commodity. The receipt can then be used as collateral – typically, the receipt would be issued in two parts, one part evidencing the commodity ownership, the other part, the right of pledge created against the commodity for the benefit of the holder of that part.

The EBRD investment experience and the FAO/World Bank study “The use of warehouse receipt finance in agriculture in transition countries” clearly show that an appropriate legal framework is a prerequisite for a well-functioning warehouse receipt system. The system hinges on four pillars which increase reliability of the warehouse receipts and thus its acceptability by financiers:

1. The modern grain warehouse receipt should be a document evidencing that defined commodities were deposited at a licensed warehouse which undertakes to keep safely the commodities and hand them over on demand to a person in possession of the receipt.
Providing for warehouse receipts in legislation is not sufficient to build a reliable system that can flourish.

2. The protection of depositors or receipt-holders against fraud is provided by an indemnity fund.

3. The system used for receipt issuance must provide an optimal level of protection against fraud by preventing the forging of warehouse receipts. Electronic register of issued warehouse receipts can be a good approach.

4. The enforcement of secured creditors' rights is facilitated by an efficient out-of-court enforcement which would provide the secured creditors with the opportunity to directly sell or take the warehoused goods from the warehouse operator without further involvement of courts.

Providing for warehouse receipts in legislation is not sufficient to build a reliable system that can flourish. As mentioned, it is an entire infrastructure that must be put in place. A number of EECA countries have done so: grain warehouse receipts systems have been built in Bulgaria, the Czech Republic, Hungary, Kazakhstan, Lithuania, Poland and the Slovak Republic, with reform still ongoing in Serbia, Ukraine and Russia. The EBRD has often been instrumental in the process, as have the FAO and United States Agency for International Development (USAID). The importance of having all pillars as part of the reform package was highlighted in the Croatian case. Croatia introduced the grainhouse receipt law in 2009 but the Croatian banks refused to lend against it since both pledging and out-of-court enforcement of the instrument were seen as inefficient. Only when the indemnity fund was set up in 2010 and the law modified in 2011, did the lending against the receipts follow.

It is believed that the SEMED countries also need to build such an infrastructure as there is no modern warehouse legislative framework in place.

Conclusion

The Bank's 20 years of experience in EECA has demonstrated that legal reform is a lengthy process and remains a permanent work in progress. The operational implications of reform aiming at access to finance differ from one country to another, depending on the approach taken and the various economic and political factors at play.

Initial assessment of the SEMED countries has revealed that the existing legal framework limits access to finance by relying on rather obsolete legal solutions, in particular in the case of secured transactions. However these limitations, coupled with the raised ambitions in the post revolution area, may in fact be an opportunity to engage in legal reform. The choice of approach to reform rests on the local government and stakeholders and ultimately, it is the end result that matters. A reformed legal system should bring clear and simple solutions, increase legal certainty and improve availability of finance for generations to come.
Focus section: Financial law reform: from Moscow to Casablanca

Notes

1 For more information on the work of the LTP, please visit http://intranet.ebrd.com/ebrdnet/depts/ogc/about/ltteam.shtml


3 Egyptian Law No. 11/1940, Moroccan Commercial Code Law No. 15-95, Tunisian Commercial Code, similar concept found as well in Jordanian Law No. 1/2012.

4 The assets subject to a "Fonds de Commerce" mortgage are limited to the title, the trade name, leasing or similar rights relating to real property, goodwill including the right to acquire and contact clients, trademarks, licenses and permits related to the "Fonds de Commerce", movables, for example, furniture, furnishings and equipment related to activities of the "Fonds de Commerce". Article 9 of Law No. 11 of 1940 regulating the Sale and Mortgage of "Fonds de Commerce" in Egypt.

5 Under Articles 11 and 12 of the Egyptian "Fonds de commerce" Law, a "fond de commerce" mortgage must be notarised and registered within a period of 15 days from the date of the mortgage agreement. Otherwise, the mortgage becomes null and void. Such registration should take place in the Commercial Register with jurisdiction over the branch of the business or the place where its assets are located.


7 Basic Proprietary Relations Act, Official gazette of the SFRY 6/80, 36/90 and Official gazette of the Republic of Croatia 53/91, 91/96

8 Property Act, Official Gazette of the Republic of Croatia, 91/96, 73/00, 129/00, 114/01, 79/06, 141/06, 146/08, 38/09.

9 Enforcement Act 1996. Official Gazette of the Republic of Croatia 57/96, 29/99, 42/00, 173/03, 194/03, 151/04, 88/05, 121/05, 67/08, which was later replaced by Enforcement Act 2010, Official Gazette of the Republic of Croatia 139/10, 125/11, 150/11, 154/11, 70/12, which was most recently replaced by Enforcement Act 2012, Official Gazette of the Republic of Croatia 112/12.


11 East Agri is an informal platform for sharing information, best practices and lessons learned on agricultural and agribusiness financing and rural development among key practitioners working in eastern Europe, Central Asia and the Caucasus. Created in 2002, East Agri has 24 institutional members and 200 individual users. Its founding members are: the Food and Agriculture Organization of the United Nations (FAO), the European Bank for Reconstruction and Development (EBRD), the World Bank and the Central European Initiative (CEI)., http://www.eastagri.org/about.asp


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