# IMPROVING ACCESS TO FINANCE FOR SMES

## Opportunities through Credit Reporting, Secured Lending and Insolvency Practices

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WORLD BANK GROUP

# Contents



*Cover image by Édgar Chávez*

# Acknowledgements

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# Introduction

Small and medium enterprises (SMEs) account for over 90% of firms worldwide.[1] A joint IFC and McKinsey study in 2010 estimated the total number of formal and informal micro, small and medium enterprises globally at 420-510 million, with the majority of firms—365-445 million—located in developing economies.[2] SMEs play a critical role in the global economy. They are the most significant contributors to employment and generate the majority of jobs in developing economies.[3] SMEs are also a substantial contributor to overall value added in these economies.[4] Recognizing the importance of SMEs, the World Bank Group's SME finance portfolio includes almost $4.8 billion in active lending, with 61 lending projects in 47 economies worldwide as of January 2018.[5]

Nevertheless, SMEs face greater financing obstacles than larger firms—they enjoy less access to external finance and face higher transactions costs and higher risk premiums.[6] Almost 70% of SMEs do not use external financing from financial institutions, and another 15% are underfinanced. The total credit required to finance these SMEs fully is over $2 trillion, equivalent to 14% of total developing economy GDP.[7]

Cross-country studies show that the probability of being credit constrained decreases as firm size increases and that SMEs in the least-developed regions like Sub-Saharan Africa, East Asia and the Pacific and South Asia are more likely to encounter significant financing obstacles.[8] Not surprisingly, access to finance has been identified as one of the most critical constraints to firm growth. On the other hand, availability of external finance is positively associated with indicators of entrepreneurship such as the number of startups and firm dynamism and innovation.[9]

## WHO EXTENDS CREDIT TO SMEs?

Commercial banks, credit unions and cooperatives have traditionally provided the bulk of credit to SMEs. A recent survey of 91 banks in 45 economies found that banks perceive the SME segment to be profitable, but macroeconomic instability in developing economies and competition in the SME segment in developed economies were identified as the main obstacles to them providing financing to SMEs. Banks are less exposed to SMEs than to large firms, provide a lower share of investment loans to SMEs and charge them higher fees and interest rates, especially in developing economies.[10] In Kenya, Nigeria, Rwanda, South Africa and Tanzania, the share of SME lending in the overall loan portfolios of banks varies between 5 and 20%.[11] In Ghana, bank loans account for less than one-quarter of SMEs' total debt financing and the age, size and asset tangibility of firms are positively associated with the bank-debt ratio.[12] However, new research also shows that banks can position themselves to treat SMEs as a core and strategic business. Indeed, there is real potential for small and niche banks to overcome the opaque nature of SMEs through relationship lending and for large and multiple-service banks to offer a wide range of products and services on a large scale through the use of new technologies, business models and risk-management systems.[13]

Beyond traditional lending, leasing is an important way for SMEs to expand their access to short- and medium-term financing. When leasing, a firm make a small down payment and a series of subsequent payments for the use of production assets and equipment. At the end of the lease term, the firm can purchase the assets from the lessor by making a minimal buyout payment. Leasing enables SMEs to preserve cash for profit-generating activities. A recent study found that the share of total annual finance and operating leases is considerably higher among small firms (which have average interest rates that are higher than their large counterparts) and high-growth firms (which face higher agency cost premiums on marginal financing).[14] As the lessors retain ownership of the leased assets throughout the life of the contract, these assets become a form of collateral and ease access to finance for SMEs, particularly in economies where weak collateral laws hinder bank lending.[15] The separation of ownership and control of the leased asset also facilitates a simple recovery procedure, even in weak legal and institutional environments.[16]

Trade credit, where goods and services are supplied before payment, is another critical source of financing for SMEs. It typically consists of an open, unsecured, short-term line of credit. Transactions using trade credit simplify the cash management of firms and allow them to reduce precautionary cash holdings and to hold interest-earning assets instead. Evidence shows that small firms with less well-established banking relationships hold significantly higher levels of accounts payable. Similarly, firms operating in less well-developed financial markets carry higher levels of implicit borrowing in the form of trade credit.[17] Suppliers lend to constrained firms because they have a comparative advantage in getting information about buyers, can liquidate assets more efficiently and have an implicit equity stake in the firms. In economies with weak financial institutions, industries with a high dependence on trade credit financing also exhibit high rates of growth.[18] During monetary contractions, small firms reduce loan growth while increasing their use of trade credit—a substitute credit—to balance their loan demand.[19]

Microfinance institutions also help to bridge the credit gap by providing small loans to small businesses and new entrepreneurs, especially in rural and poor areas. These microcredit loans use collateral substitutes (such as group guarantees) and can increase over time based on sound repayment patterns. The microfinance industry, estimated to be worth $60 to $100 billion globally, has experienced unprecedented growth over the past 20 years. Several thousand microfinance organizations now reach an estimated 200 million clients, most of whom were not previously served by the formal financial sector.[20] In large markets, such as Mexico and South Africa, commercial banks and consumer lending companies have expanded their activities to include microfinance for low-income households.[21] Microcredit benefits low-income populations and enterprises that are typically small, labor-intensive and growing. In Bangladesh, for example, the Grameen Bank provides credit for the purchase of capital inputs and promotes productive self-employment among women and the poor.[22] In Uganda, Kenya and Tanzania, the Women's Microfinance Initiative offers loan programs that give women the opportunity to build a business that can generate income to improve household living standards. The incomes of microcredit clients have been found to increase by 100 to 400% after the first six months.[23]

Utility providers—which require customers to enter into a contractual arrangement and bill them after the fact, according to their usage of service at the end of each month—theoretically extend unlimited credit to entrepreneurs. Today, about 40% of adults worldwide do not have an account at a bank, or with another type of financial institution or mobile money provider.[24] Entrepreneurs—especially those from the poorest 40% of households—are at a disadvantage when seeking to establish credit histories with mainstream credit providers. In Colombia, 31.7% of the 16 million new loans made in 2014 were granted to young people between 26 and 35 years old, many of whom had entered the credit market for the first time through the telecoms sector.[25] Collecting data from utility companies and telecoms makes extending credit easier. A recent study in the United States finds that the acceptance rate for new loans increases by 10% when data from energy utilities (and 9% for telecoms) are included in the consumer credit reports, while the default rate declines by 29% (and 27% for telecoms).[26] In a one-year period, 16% of "thin-file" borrowers—that is, borrowers with few, if any, credit accounts—whose credit reports included utility data opened a new credit account, compared with only 4.6% of those whose credit reports only included traditional data.

## OPPORTUNITIES FOR IMPROVING SME FINANCING

Lack of credit information is a factor that contributes to the constraints faced by SMEs as assessing their creditworthiness represents a unique challenge. Compared to larger firms, it can be more difficult for an SME to develop a credit history as they have less access to traditional sources of finance such as banks and other financial institutions whose data is typically used in the production of credit reports. At the same time, SMEs do not generally have access to fixed assets, such as land or buildings, which are usually required by banks as collateral to secure loans. Instead, SMEs mainly rely on movable assets to access finance. Finding alternatives to traditional collateral-based lending and using collateral registries to promote adequate legal and institutional protections, therefore, enable SMEs to access the resources they need to launch and operate their businesses. Facilitating SME financing through insolvency practices also plays a crucial role in the SME lending process because the default recovery rules that are part of insolvency regulation influence creditors. However, most insolvency frameworks are not well-suited for dealing with SME loans and there is insufficient evidence to suggest that targeted SME-friendly insolvency practices improve SME access to finance.

One way to reduce financing obstacles for SMEs is to strengthen the infrastructure that supports financial transactions, including laws, regulations and institutions to create, register and enforce collateral, insolvency regime and credit reporting tools.[27] Studies show that, in economies with adequate creditor protections, the bank credit financing gap between large and small firms decreases[28] and that credit granted in a supportive legal environment is provided on more favorable conditions.[29] However, there are few practical guidelines on how to implement improvements to the financial infrastructure.

This report focuses on practices aimed at improving SMEs access to finance in three areas—credit reporting, secured lending and insolvency. Each section uses data collected by the *Doing Business* team to describe how various practices recommended by existing research have been implemented in economies across the world. The first section on credit reporting discusses four practices: (i) improving borrower identification when it comes to SMEs, (ii) identifying and including more sources that report information on SME borrowing, (iii) facilitating comprehensive delivery of financial information and (iv) developing credit reporting products customized for SMEs. The second section on secured lending considers the importance of collateral registries in SME lending. This section further looks at two alternative lending mechanisms that may be better suited for SMEs than traditional security interests—factoring and financial leasing. The third section on insolvency provides information on three practices that can be used as alternatives to formal insolvency proceedings: out-of-court settlements, pre-insolvency proceedings and specialized proceedings designed for SMEs.

## NOTES

[1] Beck 2013.
[2] Stein, Goland and Shiff 2010.
[3] Ayyagari and others 2011a.
[4] Ayyagari and others 2011b.
[5] Data as of January 2018. For more information, see http://projects.worldbank.org.
[6] Beck and Demirgüç-Kunt 2006.
[7] Stein, Goland and Shiff 2010.
[8] Kuntchev and others 2013.
[9] Beck 2013.
[10] Beck, Demirgüç-Kunt and Martinez Peria 2008.
[11] Berg and Fuchs 2013.
[12] Abor and Biekpe 2007.
[13] De la Torre, Pería and Schmukler 2010.
[14] Slotty 2009.
[15] IFC 1996; IFC 2009.
[16] Eisfeldt and Rampini 2009; Beck and Demirgüç-Kunt 2006; Berger and Udell 2006.
[17] Petersen and Rajan 1997.
[18] Fisman and Love 2003.
[19] Nilsen 2002.
[20] World Bank 2015.
[21] World Bank 2015.
[22] McKernan 2002; Schuler and Hashemi 1994; Steele, Amin and Naved 2001.
[23] Women's Microfinance Initiative 2016.
[24] Demirgüç-Kunt and others 2015.
[25] El Tiempo Economía. 2015. "Gracias a la compra de celulares, jóvenes entran al mundo del crédito." 2015. March 26.
http://www.eltiempo.com/economia/sectores/indicadores-de-credito-en-colombia-analisis-de-datacredito/15470719
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[27] Beck and Demirgüç-Kunt 2006.
[28] Galindo and Micco 2004.
[29] Maresch, Ferrando and Moro 2015.

# Improving Access to Finance for SMEs through Credit Reporting

Information asymmetries arise when borrowers know more about their financial situation and investment opportunities than lenders do. This leads to inefficiencies in the lending market as lenders have insufficient information to assess the risk represented by potential customers. In the presence of adverse selection, credit rationing takes place as potential borrowers are denied loans even if they are willing to pay more than the market interest rate or to put forward additional collateral.[1] By sharing credit information, credit reporting service providers (CRSPs)—which includes credit bureaus and credit registries—help to reduce the asymmetry of information between lenders and borrowers. CRSPs are an essential part of the financial infrastructure that facilitates access to formal finance. This chapter explores the challenges of increasing access to finance for SMEs through credit reporting and identifies areas of opportunity to enhance its positive impact.

In the presence of information asymmetries—and due to the particular characteristics of small and medium enterprises—SMEs face more difficulties in gaining access to finance than larger firms. Research on the determinants of access to finance indicates that size is one of the main factors affecting the probability that firms will face financial constraints, particularly in developing economies.[2] SMEs also tend to rely more on trade credit and informal sources (such as money lenders, friends and relatives) to finance their working capital and investments.[3]

Without hard information on the risk of borrower default, an adequate assessment of borrower creditworthiness requires lenders to develop a closer relationship with the borrower and to rely more heavily on soft information. Research on Mozambique's microfinance market, for example, shows that overcoming information asymmetries is dependent on the intensity of the relationship between lender and borrower.[4] Such relationships are of particular importance in developing economies, where the information available on microfinance borrowers is more limited in scope in comparison to businesses in the developed world that follow more transparent and stronger accounting standards.

In some regions, SMEs face significant challenges in gaining access to finance. Around one-quarter of firms (23 to 25%) in Sub-Saharan Africa, East Asia and the Pacific and South Asia, for example, are classified as fully credit constrained.[5] These firms were unable to obtain external financing in the previous year despite actively seeking credit or were discouraged from seeking credit due to the unfavorable terms and conditions of a proposed loan. Small and medium enterprises in Sub-Saharan Africa, in particular, are 19% less likely to obtain a loan than in other regions of the developing world.[6] In the Middle East and North Africa, banks identify weak financial infrastructure and a lack of SME transparency as the main obstacles to extending credit to SMEs.[7] Since 2005, 80% of the region's economies have reformed their credit information systems. However, on average, less than one-quarter of the adult population in the region is covered by a credit reporting system.

## IMPORTANCE OF CREDIT REPORTING FOR SME FINANCING

Credit reporting systems help to bridge the information gap between borrowers and lenders. Credit reporting allows lenders to learn more about borrowers' characteristics, past behavior, repayment history and current debt exposure. With this information, lenders can price their loans using a more comprehensive risk assessment of their clients. Research exploring the positive effects of credit reporting in credit markets has found that the presence of information-sharing arrangements helps to attenuate the problems of adverse selection and moral hazard brought about by asymmetric information. In economies where credit information is shared, bank lending is higher and credit risk is lower than in those economies where these arrangements are not available.[8] The presence of information sharing is also positively associated with a higher ratio of private credit to GDP particularly in developing economies.[9] Small and medium firms also tend to have a higher share of bank financing in economies where private credit bureaus exist.[10]

In the United States, a study of 31,880 small business loans from 1984 to 2001 found that credit scoring has the effect of increasing the physical distance between borrowers and lenders. Thanks to credit scoring, lenders can use hard information on the creditworthiness of clients when making lending decisions instead of relying on soft information obtained through personal interactions.[11]

By facilitating the exchange of information, credit registries and bureaus help creditors to win new borrowers and to price loans correctly. A 2008 survey of 91 banks in 45 economies documented that the availability of credit information is a critical factor in SME access to finance, particularly in developing economies where 70% of banks reported that the presence of a credit bureau facilitates lending to this category of borrower.[12] In the economies of Eastern Europe and the former Soviet Union, information sharing among banks is associated with the improved availability and lower cost of credit to firms. The effect is stronger for firms that do not have external auditors or international accounting standards, as is the case with many SMEs.[13]

Policies targeted at increasing the accessibility of credit information can help to extend credit to smaller firms. According to one study, the implementation of reforms which introduce and improve credit reporting schemes through private credit bureaus have a significant effect on firm financing. These effects include a 7 percentage point increase in the likelihood of access to finance for firms—with an additional 7 to 8 percentage points for micro and small firms—and a drop of 5% in interest rates.[14]

Expanding credit reporting to increase access to finance for SMEs presents unique challenges. The first principle of the World Bank's General Principles for Credit Reporting is that "credit reporting systems should have relevant, accurate, timely and sufficient data—including positive—collected on a systematic basis from all reliable, appropriate and available sources."[15] However, due to their size, age and reporting requirements, it may be more challenging to properly identify and collect adequate financial and credit data on SMEs compared to larger firms. The sufficient collection of data is essential to ensure that CRSPs produce comprehensive credit reports on SMEs.[16]

## WHAT ARE GOOD PRACTICES IN CREDIT REPORTING—AND HOW OFTEN ARE THEY USED?

The *Doing Business* team collected data from CRSPs in 190 economies and identified four elements that contribute to improving the quality and scope of credit reporting for SMEs. These four elements are: (i) identifying SME borrowers to link them to the credit data available to CRSPs; (ii) integrating alternative sources of data—in addition to banks and regulated financial institutions—in credit reporting; (iii) expanding the types of information available on SMEs, including their field of activity, financial standing, and financial and non-financial obligations; and iv) customizing specific products that target the SME sector.

*IDENTIFYING SME BORROWERS*

Firm identification is critical in any comprehensive commercial credit report as it constitutes the cornerstone of an accurate credit data collection, matching and distribution process. If the credit report erroneously links credit history data to the wrong firm, the report becomes useless and potentially harmful.[17] Therefore, the data and mechanisms used by CRSPs to identify the firm must be reliable and robust enough to catch both human error and attempts at fraud. The data must also be updated regularly to reflect relevant changes in the life of a firm and its owners (and any others taking loans and making repayments on the firm's behalf). CRSPs most commonly use a business registration or incorporation number, firm name and taxpayer identification number to identify a firm (figure 1.1). Less widely used identifiers are a firm's physical address, the names of the firm's owners and global legal entity identifiers. Some CRSPs employ additional identifiers such as the date of a firm's registration, its field of business activity, activity statuses and the legal form of ownership. More than 60% of CRSPs use between two and four identifiers to confirm the identity of a firm and 18% use five or six.[18]

**FIGURE 1.1 Registration or incorporation numbers are most commonly used by CRSPs to identify firms**
Share of CRSPs that identify firms using various identifiers (%)


*Source: Doing Business* database.
*Note:* Includes data for 171 CRSPs that reported data on firms.

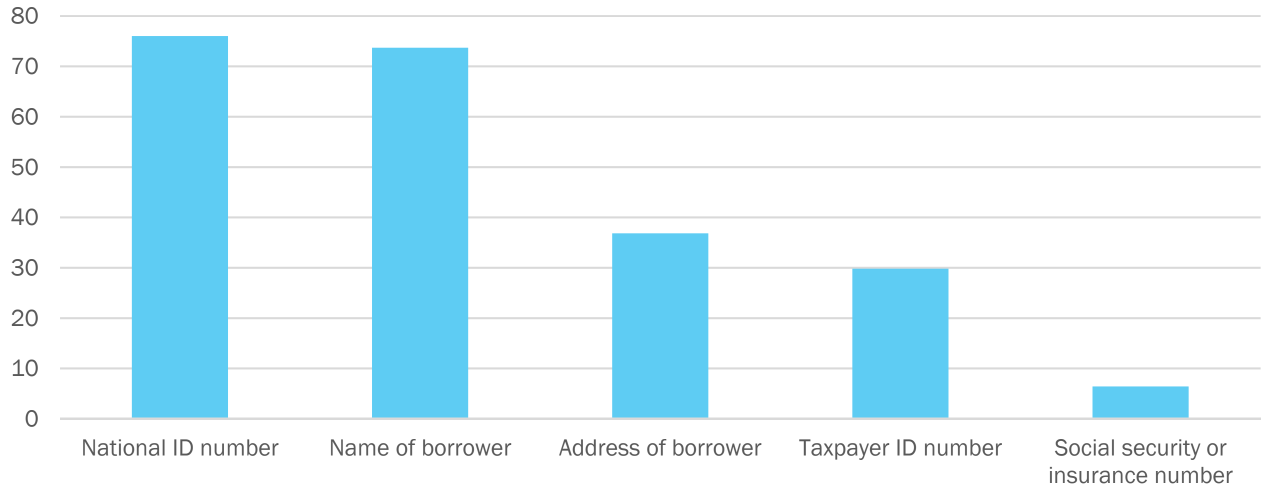
CRSPs face several obstacles when linking credit data to the relevant SME. First, CRSPs receive identification information—such as the firm's taxpayer identification number or corporate registration and incorporation number—directly from the lender, which has obtained this information from the SME. Depending on the legal and regulatory framework of an economy and the online availability of public data sources, CRSPs are not always able to cross-check the accuracy of the identification data against databases administered by the respective public agencies. Second, many economies have more than one identification number (for example, a tax identification number and a social security number) which can lead to the misidentification of a firm or the duplication of credit files. Third, SME identification numbers are affected by changes in business structure, such as mergers and acquisitions, as well as the life cycle of a firm, such as the closure and re-opening of a firm under a different name.[19] Also, the reluctance of some SMEs to formally register—resulting in the lack of identification numbers for use in collecting data on their borrowing history—can further complicate the process of SME identification.

Depending on the economy, between 10% and 30% of firms go out of business within the first two years of entering the market, and 20% to 60% do not survive beyond five years.[20] With most firms starting out small and remaining SMEs in their initial two- to five-year-period, credit reporting on SMEs is particularly affected by high entry and exit rates.

Using the name of an individual can also help to identify a firm correctly. Because individual credit files are permanent, linking the personal credit files (with consent) of proprietors, owners or directors with credit obtained in the SME's name reduces the probability of incorrect firm identification. Nineteen percent of CRSPs use the name of a firm's owner as an identifier for the firm (figure 1.1). To identify an individual, CRSPs most frequently use that individual's national identification number and the borrower's name; the borrower's physical address, taxpayer identification number and social security or insurance numbers are used less frequently (figure 1.2). Other individual identifiers used by CRSPs include the borrower's place and date of birth, their profession and the names of their parents and spouse.

FIGURE 1.2 Individual borrowers are most commonly identified by CRSPs using national identification numbers

Share of CRSPs that identify individuals using various identifiers (%)




*Source: Doing Business* database.
*Note:* The figure includes data for 171 CRSPs that report data on individuals.

There are manifold ways to identify a firm, but there is no uniform way to identify a firm across all economies. SMEs that engage in international trade need access to financing tools, such as letters of credit and trade credit, in the economies where they conduct business. The need for a single identification tool was felt acutely during the financial crisis of 2008 when government regulators and firms lacked the means to quickly evaluate the risk and exposure in their networks of market participants associated with the collapse of

Lehman Brothers.[21] Following a 2011 request from the G20 to address the challenge of unique global identification, the Financial Stability Board created the Global Legal Entity Identifier (GLEI), a 20-digit alpha-numeric code that facilitates the unique identification of legal entities engaged in a financial transaction. The GLEI system currently consists of a Regulatory Oversight Committee (ROC, consisting of public authorities), the GLEI Foundation (GLEIF, a not-for-profit organization created to support the implementation of GLEI) and 27 issuing organizations[22] (responsible for verifying the reference data provided by legal entities and issuing GLEIs). Regulations have been issued requiring the use of GLEI in the United States and some European economies. Legal entities from around the world can obtain a GLEI from any of the 28 issuing organizations.[23] By January 2018, more than one million entities from over 200 countries and territories had obtained LEIs from 30 operational issuers endorsed by the ROC or accredited by the GLEIF.[24]

Some CRSPs, including credit registries in Germany and Spain, use GLEIs to identify firms. However, only a tiny percentage of CRSPs globally use GLEIs in credit reporting. More extensive use of GLEIs will make firm identification easier and more accurate, generating benefits for SMEs, credit issuers and regulators at both the national and international levels.

*EXPANDING DATA SOURCES*

Private and public entities that extend credit to SMEs have payment information that can help other parties to assess a firm's creditworthiness. The most common creditors in the developed markets for small firms include commercial banks, other non-bank financial institutions and credit card issuers. Even for SMEs that do not have a traditional banking relationship, real-sector companies (such as suppliers that provide trade credit) and non-financial creditors (such as retailers and utility providers) can provide valuable information on a firm's repayment history, allowing potential lenders to assess their creditworthiness. Some entities also collect and compile court judgment data and sell them to CRSPs to complement the data collected under reciprocity arrangements. These "non-traditional" sources of data—such as data on payments associated with finance corporations and retailers—bolster information on thin-file clients who are not typically covered by banks and other regulated financial institutions.

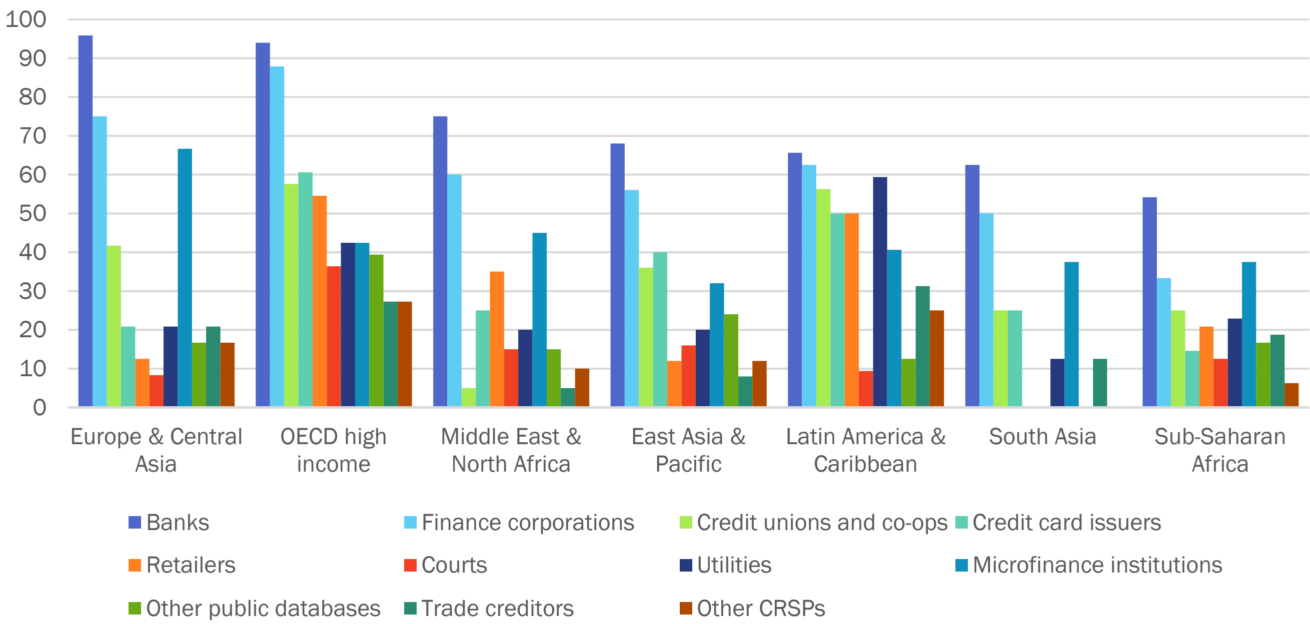
Nevertheless, to reap the benefits of expanding the sources of data in credit reporting systems some elements may require legal or practice reform. First, in some economies, the legal framework will need to be revised to allow the sharing of information from non-traditional sources. Second, even when it is permissible, the sharing of data may not be mandatory and will depend on the willingness of the potential data provider to participate. Third, potential data providers in a dominant position in their markets may not recognize the benefits of sharing information and may simply refuse to do it.

*Doing Business* collects data on which creditors submit credit information to CRSPs in 190 economies. The availability of such data can help potential lenders to assess past borrower behavior and to extend credit to small firms. A recent study shows that credit reporting is associated with the improved availability of credit and lower credit costs, especially for opaque firms such as SMEs and those operating in economies with weak legal environments.[25] Such improvements would be welcome in the Middle East and North Africa, where banks cite a lack of SME transparency and weak financial infrastructure (credit information and creditor rights) as the main constraints to lending to SMEs.[26] The introduction of new CRSPs in developing economies can increase access to credit twice as fast for small firms as for large ones,[27] with subsequent positive effects on job growth. Indeed, using the introduction of credit bureaus as an exogenous shock to the supply of credit, research finds that increased access to finance drives employment growth, particularly among SMEs.[28]

Globally, 113 of the 190 economies covered by the *Doing Business* database have at least one CRSP that reports repayment histories from finance corporations and leasing companies (figure 1.3). The OECD high-income group has the highest proportion of such economies (88%) while Sub-Saharan Africa has the lowest (33%). Leasing and credit reporting can help to facilitate greater SME financing, even in the absence of well-developed institutions.[29] In Romania, 29.6% of SMEs used leasing as a source for financing economic activities (the credit bureau, *Biroul de Credit*, receives leasing data from 25 finance corporations), followed by self-financing (64.4%) and bank loans (51.1%).[30] In Tanzania, the credit bureau “Creditinfo” expanded the “Creditors Network”—an alliance of creditors that share information about their customers’ payment behaviors—to include vehicle leasing and rental companies; its coverage increased from 0.6% of the adult population in 2014 to 6.2% in 2017. In Taiwan, China, the Joint Credit Information Center (JCIC) released the “R04 Finance Leasing Information” in February 2014—a mechanism that takes data from the finance leasing association and reports on entrepreneurs’ leasing transaction information to other potential lenders.

**FIGURE 1.3 Most economies have at least one CRSP that reports repayment histories from finance corporations and leasing companies**

Share of economies with a CRSP that report various types of data (%)




*Source: Doing Business* database.

CRSPs also report credit information from utility providers in 59 economies. The majority of these are in Latin America and the Caribbean (19) and the OECD high-income economies (14). In the United States, DTE Energy—an electricity and natural gas company—began fully reporting customer payment data to three major credit bureaus—Experian, Equifax and Innovis—in August 2006. DTE customers with no prior credit history (8.1% of the total) gained either a credit file or a credit score[31] simply by making their monthly DTE bill payments. Within six months DTE had 80,000 fewer accounts in arrears. In the United Arab Emirates, the credit bureau “Emcredit” signed an agreement with the Dubai Electricity and Water Authority and began exchanging data in 2013. The utility provider shares a list of those customers with accounts more than 90 days overdue with the CRSP and can access the CRSP's bounced check repository. Creditinfo Guyana, the country's first credit bureau, began collecting data from Guyana Water Inc. and other alternative data providers shortly after its launch in 2015 and expanded the CRSP's coverage from 2.4% of adult population in May 2015 to 16.4% in January 2016.

Europe and Central Asia is the region with the highest proportion of economies with CRSPs that report microfinance information (67%), while only 32% CRSPs in economies in East Asia and the Pacific report this information. Submitting microfinance data to CRSPs can help to mitigate the problem of asymmetric information. In India, for example, the growing microfinance market is concentrated in just a few states, leading to multiple cases of lending and over-indebtedness within the same borrower base. India's credit bureau, CRIF High Mark, added 50 microfinance lenders to its existing credit information network to help reduce credit risk and ensure informed lending.[32] Microfinance institutions in Nicaragua began sharing information in 2002 through *Sin Riesgos*—the country's first credit bureau—and subsequently through TransUnion, the international bureau.[33] In Bolivia, following the establishment of a microfinance credit reporting system, microcredit lending more than doubled from 2005 to 2008 (outpacing a 23% rise in traditional bank lending), while the percentage of nonperforming loans within the microfinance portfolio fell to 1.8%, one-third of the default rate for commercial loans.[34]

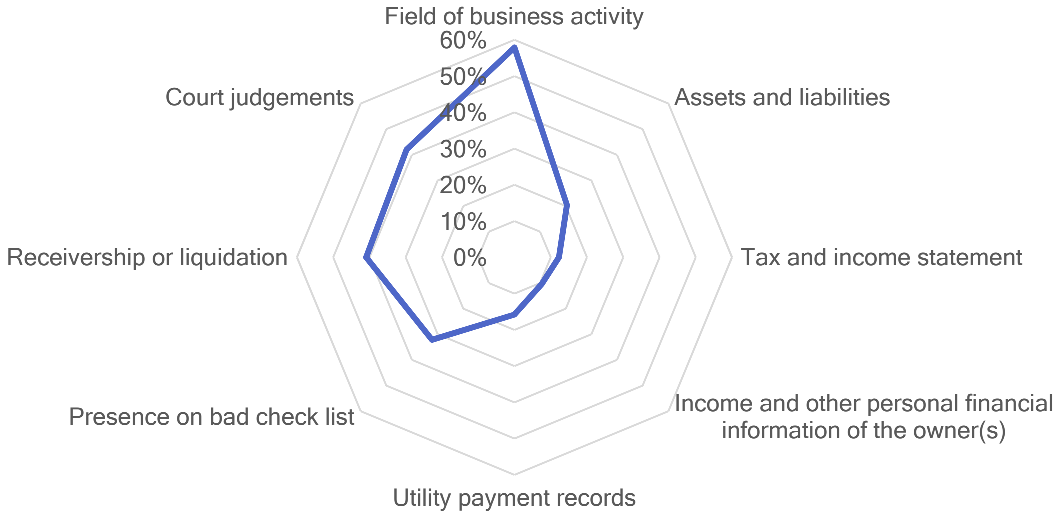
Concerning trade credit, research finds that ratings based on such data can be more reliable in predicting the ability of firms to meet credit obligations than other types of information, such as a firm's financial statements.[35] Trade credit helps to foster access to institutional funding for young firms in the early stages of the banking relationship when banks have not had the opportunity to accumulate enough soft information on them to constitute a credit history. Banks also continue to consider trade creditors as a reliable source of information on the financial conditions of firms, owing to long-established lending relationships.[36] CRSPs report data from trade creditors in only 37 economies measured by *Doing Business*. These are mainly concentrated in Latin America and the Caribbean (10), the OECD high-income economies (9) and Sub-Saharan Africa (9). In the United States, for example, Dun and Bradstreet uses trade payment data to develop the *Paydex* score for the millions of firms in its database, providing information on the likelihood that a business will meet its payment obligations to suppliers and vendors. In Bahrain, the central bank issued a circular in 2009 to allow its credit reference bureau—The Benefit Company—to extend its services to cover trade creditors, including motor vehicle dealerships that are licensed to sell on credit.

*REPORTING COMPREHENSIVE INFORMATION*

A robust credit reporting system should collect and provide accurate, sufficient and timely information to enable lenders to make comprehensive and thorough assessments of the creditworthiness of SMEs.[37] Inaccuracies may lead to unjustified loan denials or high borrowing costs. Therefore, the data reported by CRSPs should be free of error, truthful, complete and up-to-date. The data should also be updated and made available promptly so that banks and other credit sources can update their databases and submit them to the CRSPs on a regular basis (whether on a scheduled basis or within days of a pre-defined "trigger event" such as late payment or disbursement of a new loan). Furthermore, data should be sufficient to capture relevant detailed information (both negative and positive) from as many data sources as possible and to cover the period for which observations are available.

*Doing Business* collects data on what information on firm characteristics CRSPs collect and report in 190 economies. Just under 60% of CRSPs report the field of firms' business activity, 20% report their assets and liabilities and 12% report their tax and income statements (figure 1.4). All are important pieces of information, required to allow lenders to evaluate a SME's business prospects (including the broader market segment or niche in which the SME operates) and to determine the firm's repayment capacity. Forty-one percent of CRSPs report on receivership or liquidation, 42% on judicial court rulings and 32% on the presence of bad check lists, which can be useful in detecting and preventing fraudulent credit applications. Sixteen percent of CRSPs also report utility records and telephone files, where the historical repayment patterns of a firm's non-financial obligations can help to ascertain their willingness to repay, as well as their contractual financial obligations and loans. The information is reported to creditors in a standardized manner together with other system-wide information such as credit inquiries from other creditors and credit scores. CRSPs add value to the data collected from individual creditors by consolidating the various pieces of information and introducing a series of parameters, identifiers and measures to assist potential lenders in identifying the risk features of SMEs. The introduction of predictive scoring models for risk, fraud and historical performance information, adds further value.[38]

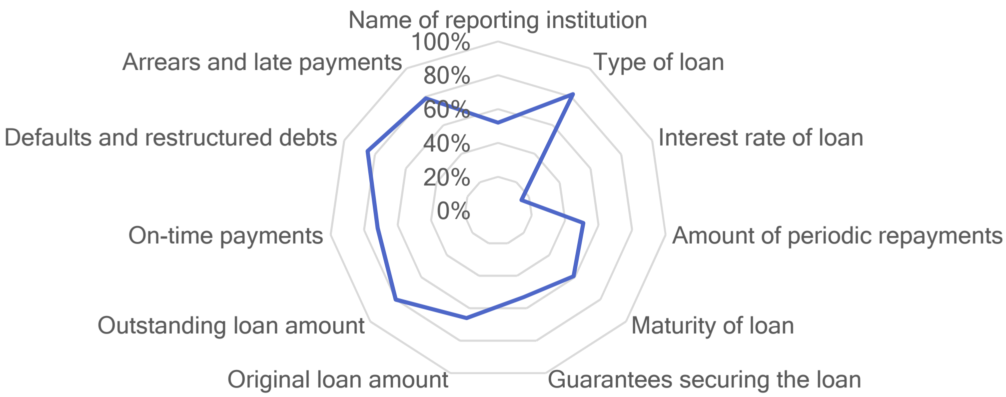
**FIGURE 1.4 The majority of CRSPs report the field of the firms' business activity**
Share of CRSPs reporting types of data on firm characteristics (%)




*Source: Doing Business* database.

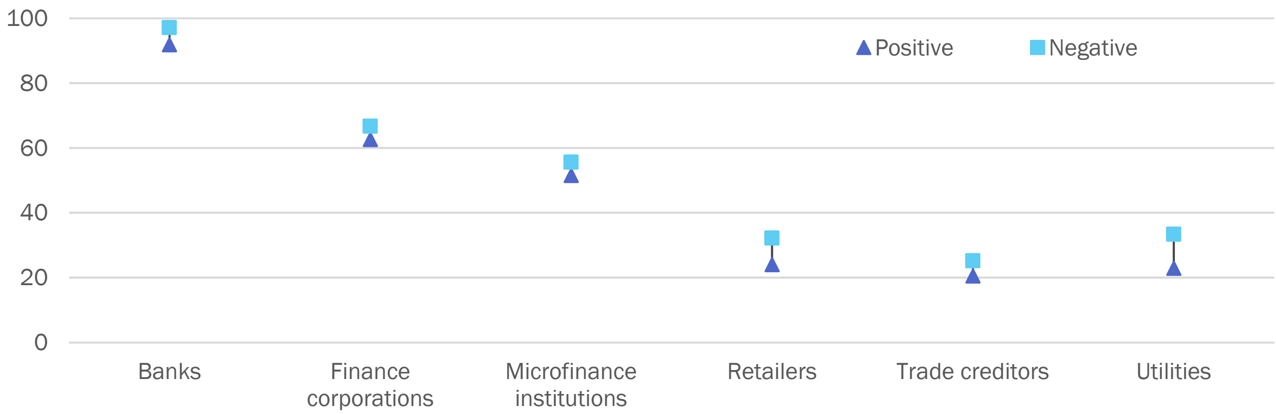
*Doing Business* also collects data for 190 economies on which information CRSPs collect and report about loans and loan repayments made by firms. Credit information can be divided into two categories*:* negative and positive. A higher share of CRSPs report negative information—indicating the occurrence of an adverse event related to unfulfilled financial obligations, such as defaults (85%) and payments in arrears (79%)—compared with those that report positive information—such as original loan amounts (66%), outstanding loan amounts (80%) and on-time loan repayments (72%) (figure 1.5). This is true across all types of data sources. Also, 59% of CRSPs report positive information on the maturity of loans, 53% on guarantees and collaterals, 51% on the amount of periodic repayments, and 15% on loan interest rates. Reporting information on timely repayment allows customers to establish a positive credit history and improves the ability of lenders to distinguish good borrowers from bad ones. A study of Latin American economies suggests that where credit bureaus distribute both positive and negative information and 100% of banks participate, lending to the private sector is greater by at least 47.5%.[39] A comprehensive credit reporting system also improves the ability of SMEs to access new financing following an adverse event, as it can progressively adjust their credit scores in response to economic recovery and improved repayment behavior.[40]

**FIGURE 1.5 A higher share of CRSPs report negative compared to positive information**
Share of CRSPs that report various types of data on loans and loan repayments of firms




*Source: Doing Business* database.

Share of CRSPs that report positive data and negative data on firms from various sources (%)

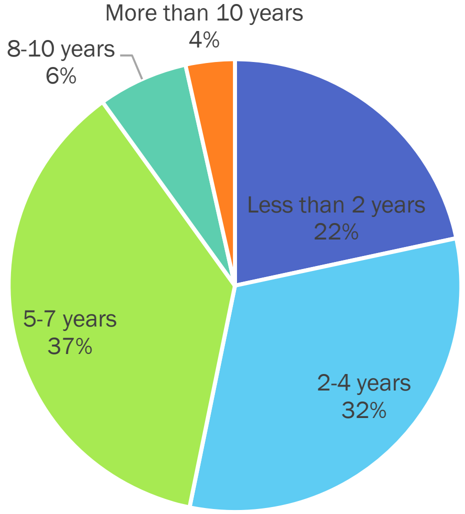



*Source: Doing Business* database.

Practices vary regarding how long CRSPs store and disclose repayment histories to potential lenders. Globally, the most common timeframe—for 37% of CRSPs measured by *Doing Business*—is five to seven years. One-third of CRSPs (32%) keep this information for between two and four years while 22% hold it for less than two years (figure 1.6). Twenty CRSPs also delete negative data related to bad debts once they are paid off, because of legal requirements or common practice in the marketplace. Deleting negative credit information cuts the amount of relevant data and reduces the predictive power of scoring models built using such data, as well as the ability of lenders to make informed decisions.[41] It also generates asymmetric information, which results in a higher perception of risk and smaller loan portfolios for SMEs.[42]

Even as new tools are developed for risk management, credit histories remain valuable. A recent study finds that as banks pay even closer attention to financial statement data following the Basel III Accord—which emphasizes the measuring and managing of credit risk—they continue to view credit histories as an important determinant of credit risk.[43] Research reveals the prevalence of using such data to evaluate the creditworthiness of SMEs[44] and finds that, in addition to financial ratios, credit histories are essential to building a rating system for the creditworthiness of SMEs under the Basel rules.[45]

**FIGURE 1.6 The majority of CRSPs report at least two years of historical data**
Share of CRSPs that report various length of historical data (%)




*Source: Doing Business* database.

*PROVIDING CUSTOMIZED PRODUCTS*

Research based on bank surveys in developed and developing economies suggests that despite the 2008 financial crisis, banks—whether small or large—view the SME sector as attractive and profitable and that SME lending is less reliant on soft information and relationship lending than previously thought. Banks use a diverse range of risk management tools when dealing with this type of potential borrower. These tools include automatic scoring methods using credit data from the SME and their owners and, as the size of the firm and the requested loan increase, these tools are complemented by standardized rating tools similar to those used for larger firms.[46]

Better tools to assess the creditworthiness of SMEs based on hard information could be viewed as a business opportunity for CRSPs, which could customize their products to help banks to evaluate the risks and pricing of loans. *Doing Business* asked CRSPs across 190 economies whether they identify SMEs as a distinct category of borrowers, and what customized products and services they offer to help banks to make more informed lending decisions. Forty-four of a total of 171 CRSPs reported that they distinguish between SMEs and other commercial borrowers. Parameters used to identify SMEs by CRSPs include, but are not limited to, the number of employees, annual turnover and total assets.

Of these 44 CRSPs, 39 link the personal credit files of proprietors, owners, or directors with credit obtained in the SME's name, a useful feature since most SMEs are microenterprises that have a single owner and manager (usually the same person). The 2014 update to the World Bank Group's Micro, Small, and Medium Enterprise Country Indicators (MSME-CI), which covered 155 economies, reported that out of 162.8 million formal MSMEs, 131.4 million are microenterprises, typically defined as firms employing fewer than 10 people.[47] Therefore, the evaluation of a firm owner's individual credit file can shed more light on the firm's creditworthiness. Experian, a credit bureau in the United States, for example, provides business-to-business owner linkage information for use in SME credit evaluations. Creditors must prove "permissible purpose" to access the files. A bureau in Zambia, Credit Reference Bureau Africa T/A TransUnion, issues a credit report that includes the details of directors and shareholders. Credit providers can then access the individual credit report of the director or shareholder with the individual's consent.

*Doing Business* data indicates that out of the 44 CRSPs which distinguish SMEs from other firms, 26 provide SME-specific credit reports and 21 provide SME-specific credit scores (box 1.1). Research has found that the use of small business credit scoring is associated with greater credit availability for SMEs, particularly riskier ones that tend to pay higher prices.[48] Other SME-specific products that are offered by several CRSPs include debt collection and tracing services, fraud detection services and the identification of women-owned and managed SMEs.

BOX 1.1 Two examples of customized products for SMEs

*SME credit scores in Thailand*

The National Credit Bureau of Thailand began offering FICO SME scores to banks and financial institutions to allow them to better assess the creditworthiness of SMEs in May 2016. The FICO SME Score, which predicts the probability of delinquency of more than 90 days in the following 24 months, is computed using an empirically derived model that is supplied with data collected by the National Credit Bureau of Thailand and Business Online Public Company Limited, a private research firm. It generates a three-digit number between 490 and 813 in eight risk bands from AA to HH, which rank-orders SMEs according to risk. The higher the score, the lower the risk.

Up to five "reason codes" are returned to the lender to help with the interpretation of the score. The FICO SME Score provides lenders in Thailand with an effective tool for rank-ordering the credit risk of SMEs. Using the scores, lenders can make lending decisions that are faster, more accurate and more consistent. Lenders can also use the FICO SME Score to support their "Internal-Ratings-Based" (Retail-IRB) approach to calculating the required minimum regulatory capital. The score applies to different types of products and lenders can use scores to make decisions across the entire lifecycle of an account.

*MSME scores in Chile*

Equifax Chile launched the Predictor Inclusion Score, a risk score derived from encrypted mobile usage data, in February 2017. When Equifax receives a credit inquiry from an unbanked person who may work for a microenterprise or small business, it checks its traditional credit database and if no record is found, it then (with consumer consent) queries the telecommunications database using the mobile number for matching. Equifax returns a score on exact cell phone number matches, calibrated to a credit score. The score allows retailers and financial institutions to evaluate financial services requests from microenterprise and small business owners, many of whom lack traditional credit and financial data.

In addition to telecommunications data, Equifax is developing analytical tools based on socio-economic relationships, retail and agricultural data to supplement traditional credit data, providing new insights on this segment that allow financial institutions to make differentiated credit offers to microenterprise and small business owners whom they were previously unable to evaluate for credit purposes.

In recent years, a round of finance and technology innovation merging big data with mobile technology engendered a new global trend in SME lending and credit reporting. The SME lending market has seen a rapid rise in the number of online lending actors, inlcuding online balance sheet lenders (like OnDeck and Kabbage), peer-to-peer transactional marketplaces (Funding circle and Lending club), multi-lender marketplaces (Fundera), payments and e-commerce platforms (Square, PayPal, Amazon), and invoice and payables financing (American Express). Many online lenders have direct, real-time access to the financial activity of SMEs through cloud-based accounting software like QuickBooks, FreshBooks and Xero. They also develop proprietary technology and algorithms for evaluating the creditworthiness of SMEs.[49] Also, alternative data from social media and online marketplaces are being used to predict repayment outcomes. Data such as the number and frequency of customer reviews, for example, on platforms like Yelp or Amazon and information on the positive or negative character of those review could be a useful data point in evaluating the growth potential of a business.[50] While the efficacy of using alternative data is tested by market participants, such data must be used cautiously with proper verification and checks, as well as in accordance with privacy regulations. Online SME lending is also expanding globally; China is the largest market with $66 billion in outstanding loans. Major players in the Chinese market include Ant Financial, Lufax and CreditEase.[51] CRSPs might consider integrating the data made available through cloud-based accounting, as well as alternative data from social media and online marketplaces, into their SME-specific products to serve their clients better and faster in both online and offline markets.

## CONCLUSION

Credit reporting is an essential element of the financial infrastructure needed to foster access to credit for SMEs. The small size, weak transparency standards and unpredictable life cycles of SMEs—in contrast to larger firms—can contribute to the generation of asymmetric information in credit markets. Nevertheless, there are unique challenges associated with effective credit reporting in this sector. One of them is being able to identify small firms correctly and to follow their repayment patterns from the moment they are created. Consistency in this area is critical and depends on several elements. For their part, CRSPs should have the capacity to utilize different identification indicators and link them effectively with the records of the owners and managers of firms. For this to be possible, the regulatory framework must provide the structure for the exchange of such information and the relevant stakeholders—including data providers, regulators and consumer groups—should be persuaded of the benefits of taking part in such initiatives.

Credit reports on SMEs are most meaningful when they provide comprehensive information on the history of firm behavior. The data show that there is room for improvement in this area. More than 40% of CRSPs, for example, report only negative data or limited positive data and in 20 economies they erase the negative information it as soon as the debts are canceled. SMEs also rely on a diverse pool of sources beyond banks to finance their production cycle and capital expenditures (for example trade creditors and microfinance institutions). In many economies, data from sources other than banks are not yet widely collected and distributed through credit reports. More comprehensive information on SMEs can better position them to develop a credit history that facilitates and improves the assessment by lenders of their potential risk.

Some CRSPs are addressing the challenge of improving access to finance for SMEs through products tailored to this particular sector. The availability of big data, cloud-based services and mobile technology expands the possibilities to use innovative methods to assess the creditworthiness of small and medium enterprises. To take advantage of these new possibilities and to increase the comprehensiveness of credit reporting, all relevant stakeholders in the credit market—including policy makers and consumer protection groups—should engage in a conversation on the best strategies to bridge the persisting information gap. In many instances, it should be the legal frameworks that adapt to the prospect of an increase in the flow of data while adopting provisions that ensure its quality and integrity and address relevant privacy concerns.

NOTES

[1] Stiglitz and Weiss 1981
[2] Beck and others 2006.
[3] Kuntchev and others 2014.
[4] Behr, Entzian and Guttler 2011.
[5] Kuntchev and others 2014.
[6] Beck and Cull 2014.
[7] Rocha and others 2011.
[8] Jappelli and Pagano 2002.
[9] Djankov, McLiesh and Schleifer 2007.
[10] Love and Mylenko 2003.
[11] DeYoung and others 2011.
[12] Beck, Demirgüç-Kunt and Martinez Peria 2008.
[13] Brown, Jappelli and Pagano 2009.
[14] Martinez Peria and Singh 2014.
[15] World Bank 2011.
[16] World Bank 2014.
[17] World Bank Group 2011.
[18] World Bank Group 2016.
[19] World Bank Group 2014.
[20] Bartelsman, Haltiwanger and Scarpetta 2009.
[21] McKinsey & Company and the Global Legal Entity Identifier Foundation 2017.
[22] The issuing organizations are in Argentina, Australia, China, Croatia, the Czech Republic, Finland, France, Germany, India, Ireland, Italy, Japan, Luxembourg, the Netherlands, Nigeria, Norway, Poland, the Republic of Korea, the Russian Federation, Saudi Arabia, the Slovak Republic, Slovenia, South Africa, Spain, Turkey, the United Kingdom, and the United States.
[23] See the website of the Global Legal Entity Identifier Foundation at https://www.gleif.org/en/.
[24] See the website of the Legal Entity Identifier Regulatory Oversight Committee at https://www.leiroc.org/.
[25] Brown, Jappelli and Pagano 2009.
[26] Rocha and others 2011.
[27] Brown and Zehnder 2007.
[28] Ayyagari and others 2016.
[29] Beck and Demirgüç-Kunt 2006.
[30] Oncioiu 2012.
[31] World Bank Conference. Financial Infrastructure Week. Brazil, March 15-17, 2010.
[32] While comprehensive credit reporting helps to promote financial inclusion, the main motivation was to address the problem of multiple lending and over-indebtedness among microfinance clients in India.
[33] Lyman and others 2011.
[34] Bustelo 2009
[35] Kallberg and Udell 2003.
[36] Agostino and Trivieri 2014.

[37] World Bank 2011.
[38] World Bank 2011.
[39] Turner and Varghese 2007.
[40] World Bank 2011.
[41] World Bank 2011. Current practices for scoring models require a period that ranges between three to seven years of data.
[42] Nizamani and Marimuthu 2015.
[43] Dainelli, Giunta and Cipollini 2013.
[44] Jiménez and Saurina 2004.
[45] Dainelli, Giunta and Cipollini 2013.
[46] De la Torre, Pería and Schmukler 2010.
[47] Gonzales, Hommes and Mirmulstein 2014.
[48] Berger, Frame and Miller 2005.
[49] Mills and McCarthy 2016.
[50] Mills and McCarthy 2016.
[51] Mills and McCarthy 2016.

# Improving Access to Finance for SMEs through Secured Lending

Rules governing secured lending are an essential aspect of an economy's financial infrastructure. They form the basis for the creditor-debtor relationship by establishing a legal and institutional framework for the use of movable assets as collateral. These rules are especially important for SMEs because they typically possess movable assets (as opposed to immovable assets), against which lenders are reluctant to lend. Effective secured transactions systems and collateral registries enable SMEs to rely on movable assets to secure financing. This chapter focuses on the importance of lending to SMEs and the difficulties associated with lending to such firms. The first section presents findings from studies that empirically demonstrate the importance of secured lending for SMEs, while the second section discusses the role of collateral registries. The third and fourth sections describe two financing instruments that are alternatives to bank loans, namely factoring and financial leasing.

## IMPORTANCE OF SECURED LENDING FOR SMEs

In developing economies, almost 80% of firms' capital stock consists of movable assets, such as machinery, equipment and receivables. Smaller firms, in particular, are less likely to have access to fixed assets like a plot of land or building. As such, movable assets are the main type of collateral that a SME can offer as collateral to secure financing. However, due to inadequate legal and institutional protections, banks are often reluctant to accept movable assets as collateral.

Studies confirm that stronger legal protections for creditors translate into greater access to finance for SMEs.One study explores the impact of creditor protections on SMEs' access to credit using cross-country firm-level data for 54 economies.[1] By testing whether the share of firms' investment financed with bank credit depends on legal protections of creditors and whether the share of bank credit is affected by firm size, the study shows that small and medium firms finance significantly less of their investment with bank credit compared to large firms. Moreover, in economies with limited creditor protections, smaller companies have significantly less access to credit compared to larger ones. As creditor rights increase, the financing gap between small and large firms decreases. Creditors are better protected when secured transactions rules define how the rights of creditors in the collateral are established, how collateral priority is determined and how notification of a lien is made.[2]

A collateral registry, which records the potential existence of security interest in movable assets, can protect the rights of creditors in secured lending. Effective collateral registries can reduce the costs of credit monitoring by notifying parties about the existence of a security interest and establishing priority of creditors against third parties. A study exploring the impact of collateral registries on firms' access to bank finance finds that introducing collateral registries is associated with both increased availability of bank credit to firms and credit at better terms (such as lower interest rates and longer loan maturity).[3] The study suggests that this impact is more significant for smaller firms.

Credit constraints mean that SMEs are more likely to use alternative financing mechanisms, such as factoring, leasing and trade credit.[4] One study, which compares firm-level survey data for 48 economies to investigate the proportion of investment that firms finance externally—and focuses specifically on the differences between small and large firms—finds that small firms use significantly less external finance, especially bank finance, compared to larger firms.[5] Another study, using a dataset covering 113 developing economies, investigates the type of credit used by SMEs to finance their working capital and investments and finds that SMEs tend to rely more on trade credit and informal sources compared to larger firms.[6] Research also suggests that factoring may be more prevalent in economies with weaker contract enforcement regimes[7] and that SMEs that are denied traditional bank financing due to lack of credit history or inability to provide sufficient guarantees can use leasing as an alternative lending mechanism.[8]

The sections below detail the role of collateral registries and two alternatives to traditional collateral-based lending—factoring and financial leasing—in facilitating access to finance for SMEs. The discussion utilizes existing literature and data from the *Doing Business* database, collected through a questionnaire administered to legal practitioners in 190 economies who are experts in the area of secured lending.

## COLLATERAL REGISTRIES

Collateral registries are publicly available databases of interests in or ownership of assets. A comprehensive and integrated secured transactions regime cannot flourish without a well-functioning collateral registry. This institutional and infrastructural mechanism supports the legal framework of security rights in movable assets by facilitating awareness of both their existence and establishing priority based on the time of registration.[9] The United Nations Commission on International Trade Law (UNCITRAL) Guide on the Implementation of a Security Rights Registry and the UNCITRAL Model Law on Secured Transactions outline international good practice underpinning the registration of security interests.[10]

### *HOW DO COLLATERAL REGISTRIES BENEFIT SME LENDING?*

Transparency and priority are the core elements that make the existence of a collateral registry relevant and a *conditio sine qua non* for SME financing. There are two perspectives when financing the establishment or expansion of a SME—that of the debtor and that of the creditor. On the one hand, companies require affordable credit—greater availability, an extended repayment period and lower interest rate. On the other hand, lenders must absorb the cost of capital, loan transaction costs and the risk of a non-performing loan. SMEs, in particular, often lack adequate credit history and proof of profitability. In SME-intensive sectors such as agriculture, for example, entrepreneurs face particular challenges such as weather risks and market fluctuations.[11] For this reason, banks require that collateral—ideally for the bank in the form of immovable property—is provided as a guarantee. Banks prefer real estate over mortgages because real estate has historically served as the vehicle of trust in transactions, mainly because owners are identifiable and regulation is comprehensive. More importantly, unlike movable property, immovable property is more difficult to destroy, hide or transfer to another person. Creditors can, therefore, ensure enforcement and debt collection.[12]

This preference for real estate explains why lenders are unwilling to provide credit when movable property is offered as collateral. However, SMEs rarely own land. In fact, 78% of firms' capital stock in developing economies is in movable assets.[13] In Latin America, for example, where wealth remains concentrated and almost exclusively land-based,[14] movable assets that could be used as collateral by entrepreneurs are instead considered “dead capital.”[15] In such a prohibitive environment, entrepreneurs either do not apply for loans to start their business or their applications are rejected due to unsuitable collateral.[16]

Efficient, secured transactions legal frameworks that allow for movable property to be recorded in collateral registries can support an increase in lending.[17] Furthermore, studies show that banks tend to increase lending following reforms to collateral laws; this is especially important in emerging economies where information asymmetries prevail.[18] Registration that is easy, quick and inexpensive encourages parties to reveal transactions that they otherwise may have concealed. Documentation may unnecessarily complicate the creation of the security right, particularly if the document requests payments and the parties enter into small repeated actions.[19] The introduction of a new collateral registry can result in a significant economic impact in bank financing. Studies show that, apart from increased access to credit, interest rates may drop by as much as 3 percentage points and repayment periods can be extended by six months.[20]

*WHAT ARE GOOD PRACTICES WHEN SETTING UP A COLLATERAL REGISTRY?*

This study builds on data collected by the getting credit indicators of the *Doing Business* project. The dataset includes 190 economies and scores economies on three main components comprised of various questions to test the existence and practical application of the good practices identified by the World Bank. Accepted standards for modern collateral registries, for example, include using notice-based registration, meaning no documentation is required to be submitted,[21] and allowing online access to data,[22] which has numerous positive effects such as saving time, costs and increasing rural financial lending for distant or smaller financial institutions.[23]

Each set of questions tested under the *Doing Business* methodology is a logical prerequisite for the next. For this case study, data on collateral registries include those where at least some recording can take place. For example, collateral registries which are paper-based can be included. Although good practices recommend online registration, paper-based registries are still captured by the methodology. That said, the economy will not receive the point awarded for having an online registry. Another example is that of a local registry, where the database only covers a particular region and does not extend to the entire economy. In this case, the point for geographic unification will not be granted. However, the additional two questions concerning collateral registries will be examined and, if the criteria are fulfilled for those questions, those points will be awarded.

The questions are focused on the existence and features of a basic collateral registry, as most recently stated by UNCITRAL.[24] These include whether:

a) a collateral registry is operating—meaning parties can use it to register and search for security rights over collateral;
b) the registry is for both incorporated and non-incorporated entities—meaning whether separate legal entities incorporated through a registration process established via legislation as well as non-registered partnerships and sole proprietorships can use the collateral registry;
c) the registry is unified geographically—meaning the coverage of the database extends to the whole economy;

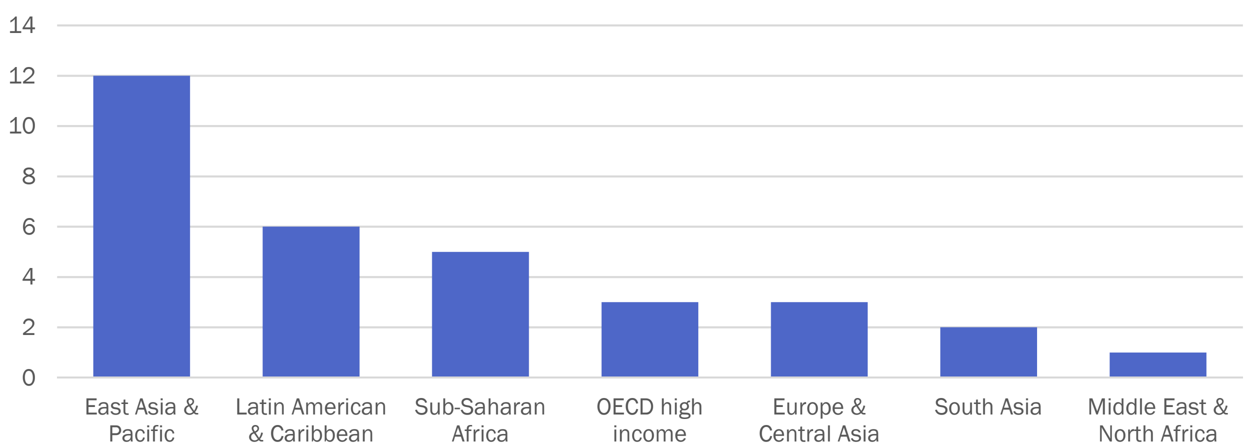
d) the registry is unified by asset type—meaning the collateral registry covers all types of security rights in movable assets (other than vehicles, ships, aircraft or intellectual property), such as machines, inventory, tangible assets and receivables which are most likely owned by small businesses;
e) an electronic database exists as part of the registry, indexed by debtor's name or a unique identifier;
f) all other security rights, in a broad sense, such as fiduciary transfer of title, financial leases, assignment of receivables and retention of title sales, can be recorded in the registry;
g) the registry is notice-based, meaning no underlying contract should be registered and no review by specialists of the documents provided and the assets used as collateral is necessary;
h) the registry is available online to the public for the registration, modification, cancelation and search by debtor's identifier; and
i) the registry is accessible to anyone without the intervention of a clerk.

The data reflect the one-year period from June 2, 2016 until June 1, 2017.

*HOW OFTEN ARE GOOD PRACTICES INCORPORATED?*

Globally, only 32 of 190 economies have collateral registries that follow all features of these good practices (figure 2.1). Twelve of them are in East Asia and the Pacific (primarily small Pacific islands as well as Brunei Darussalam, Cambodia and the Lao People's Democratic Republic). There are six economies in Latin America with modern collateral registries that employ good practices (Colombia, Costa Rica, El Salvador, Honduras, Jamaica and Mexico). In the OECD high-income region, Australia and New Zealand were among the first countries to introduce registry reforms (box 2.1). Collateral registries in Europe and Central Asia were also among the first to be established (Bosnia and Herzegovina, Uzbekistan and Montenegro). In South Asia, the collateral registries of Afghanistan and Nepal employ these good practices. Only West Bank and Gaza in the Middle East and North Africa region has an operational collateral registry. In Sub-Saharan Africa, The Gambia, Liberia, Malawi, Nigeria and Zambia recently launched modern collateral registries. Nigeria's collateral registry, for example, is now operational 24 hours per day.

FIGURE 2.1 How many collateral registries abide by good practices?
Number of modern collateral registries by region




*Source: Doing Business* database.

BOX 2.1 An example of a well-functioning collateral registry: Australia

The Personal Property Securities Register in Australia is an example of a well-functioning collateral registry. Under the oversight of the Australian Financial Security Authority—with more than one hundred full-time employees—the registry records security rights on personal property, fiduciary transfer of titles, financial leases, assignment of receivables, retention of title sales and judgment claims. Following its launch on January 30, 2012, the registry implemented a two-year transitional period, during which secured parties were provided temporary perfection of security rights. In 2014, the number of new registrations reached 2,364,310. Searches soared from 5,886,945 in 2012 to 7,315,379 in 2014, underscoring rising confidence in the new collateral registry and regime.

Registrations can be made against individual and organizational grantors, and no physical presence is required. A standard registration form is provided with free text for some collateral classes. No additional documentation is required to be uploaded to the system. A flat fee, which varies based on the registration duration, is charged. Any interested party can search online using the debtor's identifier, a serial number or a registration number, among other criteria. The registry then produces an "exact match" search. If someone is unable to perform an online search, the contact center of the collateral registry provides technical support, performing the search on behalf of the user and sending them the results via email.

Despite its high volume of records, the collateral registry has yet to receive any complaints. An administrative mechanism—known as the amendment demand process—is in place to resolve disputes, if they arise. The registrar of the personal property securities register is responsible for its administration. Were the registrar to receive a complaint that the registration of a party is invalid, the registrar would be tasked with ascertaining whether the registration should be discharged from the registry.

*Source:* Australian Financial Security Authority website (https://www.afsa.gov.au/).

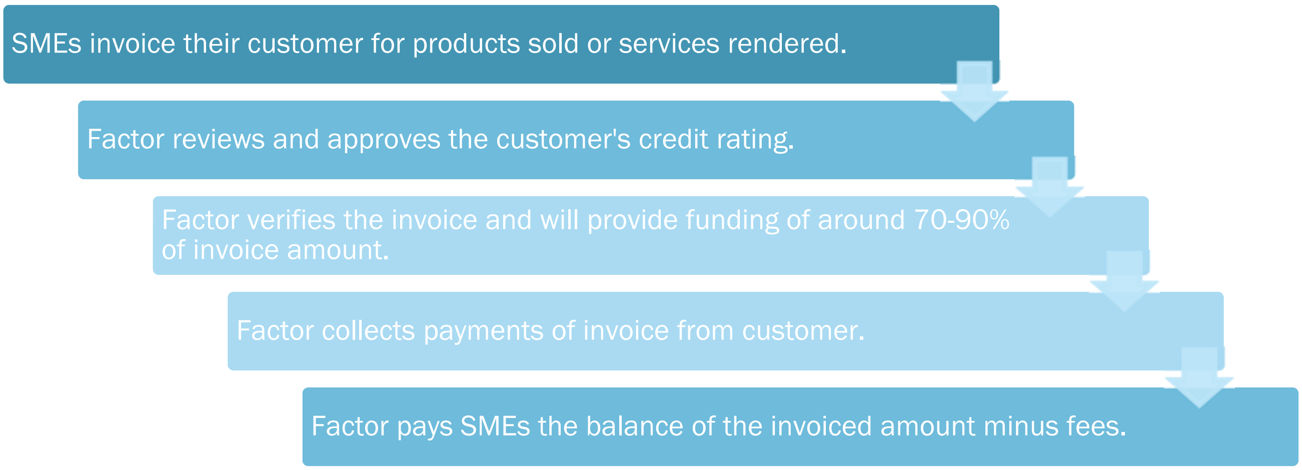
The situation is less than ideal in other economies. Indeed, most economies do not require the registration of security rights over movable property. In 22 economies, while there is a requirement to record security rights, the collateral registry could be improved by becoming notice-based, expanding registration requirements to other hidden liens and "going online, instead of in line." Five economies have notice-based collateral registries that record additional liens, but they are not online. Canada and the United States are unique since collateral registries in those countries—although modern and user-friendly—operate at the state level instead of the federal level. Other federal economies, such as Mexico, opted to unify the collateral registry into one single database.[25]

## FACTORING AND SME FINANCE

The financial concept of factoring is defined as a type of "supplier financing in which firms (seller) sell their creditworthy accounts receivable at a discount (generally equal to interest plus service fees) and receive immediate cash from a specialized institution (factor)."[26] In other terms, the factor buys the right to collect a firm's invoices from its customers, by paying the firm the face value of these invoices, less a discount. The factor then proceeds to collect payment from the firm's customers at the due date of invoices.

Factoring has three main features: (i) it exclusively involves the financing of accounts receivable; (ii) the underlying asset is sold to the factor at a discount, rather than collateralized; (iii) it is a bundle of three financial services—a financing component, a credit component, and a collections component (figure 2.2). Through factoring, it is the factor that assumes the costs implied by collecting information about buyers. In the case of “ordinary factoring,” the firm sells its complete portfolio of receivables. In the case of “reverse factoring,” the factor purchases accounts receivable only from selected customers of the firm. In this way, the factor increases its risk exposure to a customer, but the cost of acquiring information and assessing credit risk is lower, and typically only high-quality receivables are accepted.[27]

FIGURE 2.2 How factoring works in practice




*Source:* Macías Sánchez, 2011.

There are two main categories of factoring, based on the transfer of risk—non-recourse and recourse contracts. In recourse factoring, the factor has a claim against the firm for any account payment deficiency. Under non-recourse factoring, the factor assumes full title to the accounts and bears the default risk without recourse to the firm.

*HOW DOES FACTORING BENEFIT SME LENDING?*

SMEs will typically decide to factor their receivable assets for a beneficial cash flow situation, because cash is immediately generated, as opposed to waiting for buyers to submit their payments.[28] Doing so is particularly beneficial because financing and a consistent cash flow are among the biggest challenges that SMEs face in operating their business, and factoring can provide relief in numerous ways.[29] Money is often needed urgently so the business can grow and a low amount of working capital may jeopardize the business’ ability to satisfy orders from customers.

While SMEs can utilize traditional methods of seeking bank loans, lending standards tightened following the financial crisis of 2008.[30] Factoring represents a solution for SMEs to boost their cash flow because they can receive working capital financing, albeit at a discount, at a much faster rate.[31] SMEs can essentially outsource their credit collection process to the factor, which will also involve credit checks on the buyers. Furthermore, factoring is not technically a loan, which means that the money received will not be added to the SME’s debt or tie up a company’s collateral, which it may need to secure a traditional bank loan.[32]

The use of factoring imposes several costs on the SME, however—the discount charges which, based on bank interest rates, may range from 1.5% to 3% over the base rate, and the service fees, which typically range from 0.2% to 0.5% of the turnover.[33] There may also be other charges, such as those related to credit protection for non-recourse factoring agreements, which can range from 0.5% to 2% of turnover.

Factoring for SMEs faces obstacles, particularly in developing economies. In these economies credit information bureaus, for example, are often incomplete, meaning that information on smaller firms is unavailable. Developing markets also face an elevated likelihood of fraud. Owing to the lack of a supportive legal framework, there is little trust on account of false receivables or non-existing customers.[34] A collateral registry—where factors can register the receivables (whether assigned or transferred) and perfect their right in these types of assets—is essential to support factoring. Across OECD economies, non-recourse factoring is largely adopted; in emerging markets, most factoring is done on a recourse basis, due to the greater difficulties the factor encounters in assessing the risk of default.[35]

In Latin America, a small percentage of SMEs request banks loans. Between 2003 and 2010, just 33% of the SMEs in Latin America sought a bank loan; only 60% of these applicants obtained a loan. In this context, in which SMEs struggle to access bank lending, factoring is especially advantageous for SMEs as the large customers they supply are considered more creditworthy than the SMEs.[36] However, as factoring involves considerably higher implied interest rates than bank loans, factoring companies may also be vulnerable to legal challenges. For example, although factoring companies in Brazil point out that they do not charge interest, the implicit interest rate can be easily calculated, resulting in court disputes over their charging of usurious interest rates. [37]

*HOW IS FACTORING REGULATED?*

The legal framework that facilitates international factoring was issued by the International Institute for the Unification of Private Law (UNIDROIT) in May 1988.[38] To date, nine economies have ratified this convention and, in February 2016 the convention was submitted to the U.S. Senate for ratification by the United States.[39] The convention sets forth how a factoring contract is defined as well as the rights and duties of the parties involved, among other provisions,[40] and specifies that factoring should be regulated by the same laws that regulate security interests (to ensure its integration into modern secured transaction systems).

The degree of regulation governing factoring varies between economies. However, economies tend to fall into four main categories of regulatory approaches to factors. These are: (i) economies with complete government supervision, regulation and licensing of all factoring products and services, such as China; (ii) economies that require factors to obtain a full banking license issued by the central bank and compliance of capital adequacy, such as Austria, France, Italy and Mexico; (iii) economies that require registration by the factor as a financial institution, but do not regulate capital adequacy, such as Bulgaria, Croatia, Germany, Hungary, Malta, Norway, Portugal, Romania, Serbia and Turkey; and (iv) economies with no official regulation or governmental supervision, but in which membership to international factoring associations is highly advanced, such as the Czech Republic, the Russian Federation, the United Kingdom, and the United States.[41]

*Doing Business* data show that only 64 of 153 economies have regulations on factoring and only 20 economies specifically regulate reverse factoring. In many economies, reverse factoring is not a separate category—the same rules regulate these contracts as regular factoring contracts. Almost every economy that regulates factoring limits its use (57 of 64 economies). The most common restriction is that only financial institutions can act as a factor. The second most common restriction is a licensing requirement, as in Mauritius. In some economies, such as Canada, factoring companies may only engage in factoring activity. Some economies regulate factoring under the rule applicable to assignment of receivables, as is the case in Germany and Hungary. In others, like Moldova, contractual terms are limited by law.

In Latin America, factors are normally national development banking institutions that promote the inclusion of SMEs in the value chain. These institutions operate in accordance with financing criteria applicable to development banks, channeling their funds mainly through commercial banks and non-banking financial intermediaries.

Factoring can play an important role in financial systems with weak commercial laws, contract enforcement mechanisms and bankruptcy systems. Under such conditions, the virtue of factoring is that the factored receivables are removed from the estate of the SME and become the property of the factor.[42]

*HOW OFTEN IS FACTORING USED IN PRACTICE?*

Demand for factoring is high. Data derived from survey responses show that factoring contracts are common in 70 economies—44 economies where factoring is regulated and 26 economies where factoring contracts are subject to commercial law provisions. However, respondents in economies with no regulation indicated that there is little legal certainty surrounding factoring and poor standards among factoring providers, highlighting a potential area for reform.

BOX 2.2 The successful implementation of factoring practices in Mexico

Nacional Financiera (NAFIN), a Mexican development bank institution which has provided movable asset financial products since 1980, is a successful example of the implementation of factoring and reverse factoring. NAFIN, which established its factoring program with the advice of the World Bank Group, provides reverse factoring services to SMEs through its *cadenas productivas* (productive chains) program. The main feature of the program is that it links small, risky suppliers with large, creditworthy—and often foreign-owned—firms that buy from them. Small firms can then use the receivables from their larger clients to secure loans. Participating SMEs must be registered with NAFIN and have an account with a bank that has a relationship with the buyer. Following a factoring transaction, funds are transferred directly to the supplier's bank account and the factor becomes the creditor (that is, the buyer repays the bank directly). The factor collects the loan amount directly from the buyer after a period of 30 to 90 days.

NAFIN requires that all factoring services are offered without additional collateral or service fees, at a maximum interest rate of 7 percentage points above the bank rate (5 percentage points, on average), which is about 8 percentage points below commercial bank rates. All factoring is also done without recourse, which allows SMEs to increase their cash holdings and improve their balance sheets. The sale of receivables from the supplier to the factor and the transfer of funds from the factor to the supplier are done electronically.

NAFIN's electronic platform provides factoring services online, reducing costs and improving security. In fact, over 98% of all services are provided electronically, saving both time and labor costs. The electronic platform allows all commercial banks to participate in the program, giving national reach via the internet to regional banks. NAFIN has grown rapidly thanks to this technology, raising its factoring market share from 2% in 2001 to 60% in 2004. NAFIN's platform also reduces fraud, which is systemic in the factoring business in the US and other developed economies. Since only large buyers are able to enter new receivables, sellers cannot submit fraudulent receivables. Moreover, since the bank is paid directly by the buyer, suppliers cannot embezzle the proceeds. The success of the NAFIN program highlights how the use of electronic channels can reduce costs and provide a greater portfolio of financial services to SMEs. The case also underscores the importance of legal and regulatory support—Mexico's electronic signature and security laws have proven critical to NAFIN's success and could be a model for other developing economies.

Factoring provided by NAFIN to SMEs

| Year | Credit, in millions of Mexican pesos | Number of enterprises benefited | Percent of benefited SMEs | Percent of government procurement |
|---|---|---|---|---|
| 2015 | 211,776 | 6,647 | 99.8 | 42 |
| 2014 | 228,094 | 7,163 | 99.3 | 23 |
| 2013 | 250,402 | 7,100 | 99.7 | 40 |
| 2012 | 116,588 | 4,580 | 99.2 | 22 |

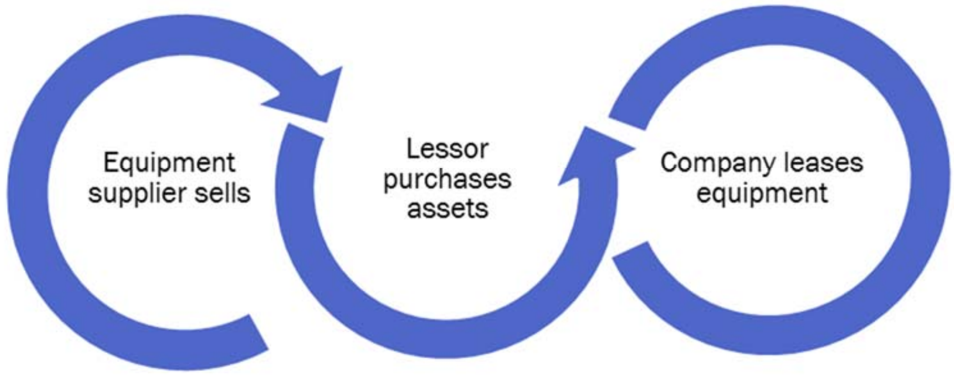
*Source:* NAFIN Annual Reports for 2015, 2014, 2013 and 2012 (http://www.nafin.com).

## FINANCIAL LEASES

Firms need alternative methods of financing to bank loans to start and operate their businesses. One of those methods, financial leasing, is a tripartite arrangement where one party, the lessor, buys the asset from the supplier upon request of the lessee and leases this asset to the lessee for a period of time in exchange for leasing payments. The amount of leasing payments may or may not amortize the cost of the leased asset.

Financial leasing is a means for a business to access medium and long-term financing to purchase the assets needed to operate the business, typically machinery. The lessor—a bank, a leasing company, a non-bank financial institution—purchases the equipment that the lessee needs from a supplier and allows the lessee to use it in exchange for periodic payments (figure 2.3). The lessor remains the owner of the asset and, a the end of the lease, the lessor may transfer the ownership of the leased asset to the lessee or the parties may agree that the asset should be returned to the lessor.

FIGURE 2.3 What is a financial leasing transaction?




Leasing differs from loans in the ownership of the asset. In a secured loan, the borrower remains the owner of the asset that serves as collateral. From an accounting perspective, in a financial lease, the lessor is the legal owner of the asset. Financial leasing also differs from operating leases (or rent). In the former, substantially all the risks and rewards of ownership of an asset are transferred to the lessee from the lessor. By contrast, an operating lease is essentially a rental contract for the short-term or temporary use of an asset by the lessee. The maintenance and insurance risks and rewards associated with the asset are not transferred to the lessee and stay with the owner of the asset, the lessor.

From a legal perspective, definitions of financial leases and other types of leases vary from jurisdiction to jurisdiction. However, the UNIDROIT Model Law on Leasing submits that for a leasing contract to be classified as a financial lease, the lessee must select the supplier and the leased asset and that such asset must be purchased by the lessor from the supplier in connection with the lease with the supplier having knowledge that the asset is to be leased to the lessee.[43] Whether the amount of leasing payments substantially amortize the cost of the leased asset—or whether the asset is transferred to the lessee at the end of the lease —may not be relevant (as is the case with the definition of lease from the accounting perspective).

There is no single model of financial leasing contracts. Although parties should have the option to tailor contracts, certain key features should be included. These are: (i) as the transaction of a lease is generally an asset-renting transaction, the legal ownership is separated from economic use; (ii) both the lessor and the lessee can be legal entities as well as individuals (sole proprietors); (iii) there will be at least two parties to a lease—the owner and the user—and in many jurisdictions a third party, the supplier of the equipment, may be required; (iv) the leased asset must be non-consumable; (v) the period for which the agreement of lease shall be in operation must be specified; (vi) lease rentals, which represent the consideration (usually monetary) for the lease transaction (that is, what the lessee pays to the lessor); (vii) specification of what will be the value of the leased equipment at the end of the lease term, or its “residual value”; (viii) the end-of-term options to the lessee; (ix) the upfront payments from a lessee, which may be the initial lease rental, advance lease rental payments, security deposit, and so on.[44]

*HOW DO FINANCIAL LEASES BENEFIT SME LENDING?*

Small and medium enterprises are disproportionately affected by information asymmetries in credit markets. Financial leasing can help mitigate such information imbalances. Several studies have shown that firms facing greater information asymmetries are more likely to seek a leasing arrangement than a traditional loan.[45] Financial leases are particularly useful to SMEs because repayments will come from income generated by the use of assets—and, in case of default, the lessor will repossess these assets—implying a reduced need for a credit history. Indeed, lessors can *ex ante* assess the probability of default and loss given default on a case-by-case basis.[46]

Financial leasing requires initial cash down payments that are less costly than the equity component in traditional bank financing.[47] Research shows that companies with poor creditworthiness use leasing more often than highly-rated companies because leasing allows them to reduce their financing costs.[48] In many economies—but particularly in Belgium, Finland, Ireland and Spain—leasing is used mainly by rapidly-expanding SMEs.[49] A study in the United Kingdom found that the reasons firms choose to use leasing depend on their size; in small firms, the decision to enter into a leasing agreement is driven by potential growth opportunities.[50] Leasing can also allow smaller firms to survive; small, less-profitable companies are more likely to lease than cash-generating firms.

For the lessor, the fact that it remains the owner of the assets can be a motivating factor, particularly in economies where the legal framework for secured transactions does not facilitate easy repayment to a secured lender. In many economies, legal ownership is recognized more readily than secured lending.[51] As such, leasing can be a good tool for lessors in more challenging legal environments.

From a public policy perspective, leasing incentivizes formality in economies where informal activity is widespread. Informal SMEs have limited access to institutional sources of finance such as banks. Once a business starts operating thanks to financial leasing, it begins to establish a credit history that becomes part of the formal credit information infrastructure. This information can then be provided to financial institutions and, ultimately, enable SMEs to access additional financial services.[52]

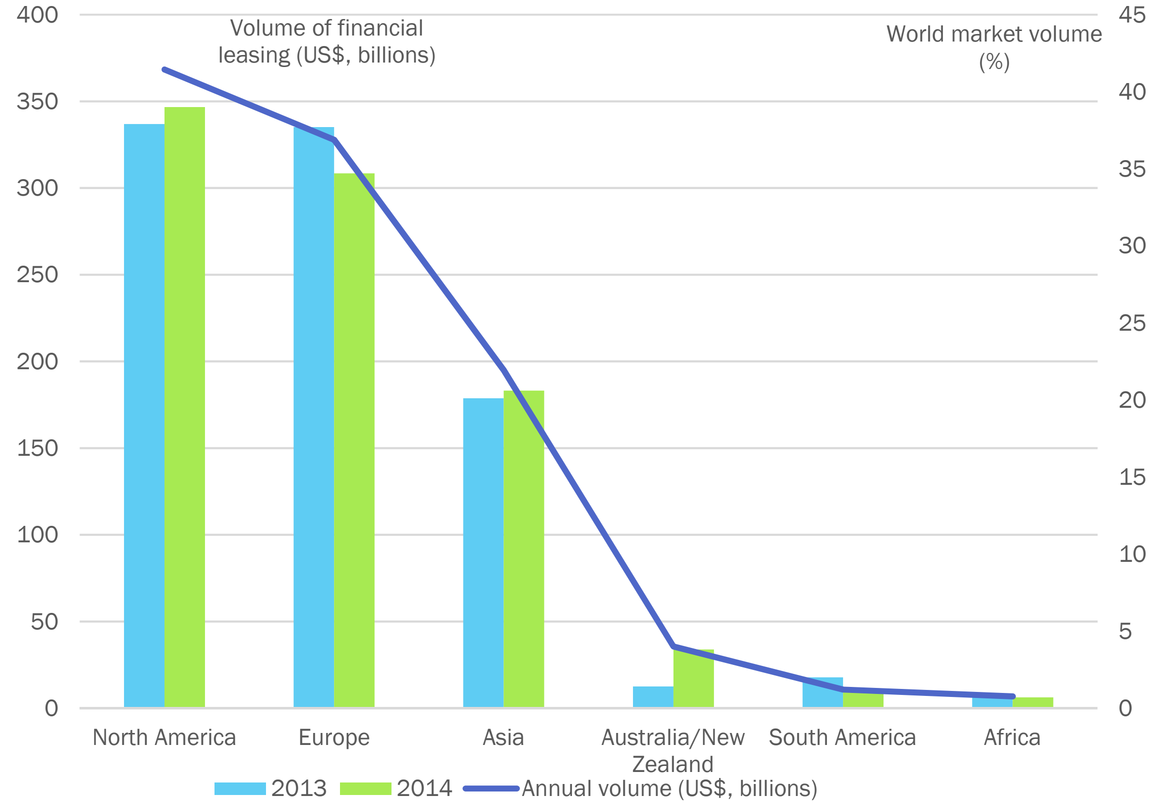
The White Clarke Group has been tracking the development of the financial leasing industry worldwide for 30 years. According to its 2016 Global Leasing Report, in 2014 three regions—North America, Europe and Asia—accounted for more than 80% of world financial leasing volume (figure 2.4).[53]

The United States is the largest financial leasing market in the world, accounting for almost one-third of the global new business volumes in equipment leasing and hire purchase.[54] Europe's share of the world market is similar, with new business volumes of $327.8 billion in 2014. With an annual volume of $78.16 billion, the United Kingdom and Germany are the dominant players in the region's lease finance industry, followed by France, Sweden and Italy.[55]

In Asia, China is driving growth in financial leasing, with a year-on-year increase of 31.1% in new business volume in 2014. China was the world's second-largest market for asset finance through leasing and hire purchase in 2014, with new business volume totaling $114.6bn.[56]

In Latin America, the volume of leasing in economies such as Colombia and Brazil amounts to about $4 billion each, almost six-times the global market share of leasing in Africa, where the leasing industry is in its infancy. That said, with an annual volume of $4.6 billion, South Africa has levels similar to that of the best-performing Latin American economies.

Figure 2.4 Financial leasing by region, 2013–2014




*Source:* adapted from White 2016.

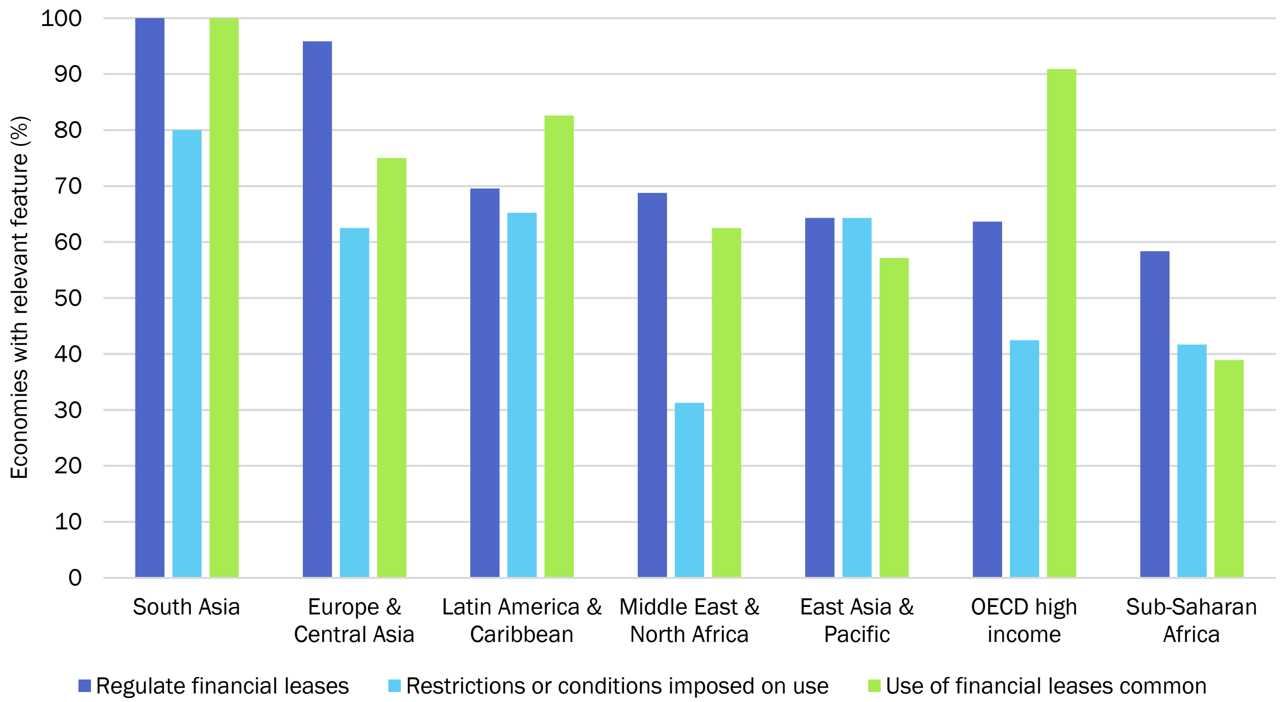
*HOW OFTEN ARE FINANCIAL LEASES USED IN PRACTICE?*

*Doing Business* data confirm that financial leasing exists in many economies worldwide—107 of 153 economies have some level of regulation for financial leases. Some regulation is comprehensive, such as in Canada, whereas others only include references to financial leasing as a type of financial activity (box 2.3).

Among economies with regulation governing financial leasing, 78 of 107 restrict this activity to some extent. The most common type of restriction requires that financial leasing is performed by a financial institution. Other common restrictions include the imposition of licensing requirements or limitations on the type of assets that can be subject to financial leases. Some economies—Lebanon and Jordan, for example—have different requirements for local and foreign companies.

Companies in 104 of 153 economies, including 21 economies where financial leasing is unregulated, commonly use financial leases. Where specific regulation is absent, leasing agreements are governed by contracts law. The bulk of economies where financial leasing is not regulated but is commonly used in practice are in the OECD high-income and Latin American and the Caribbean regions (figure 2.5). Conversely, in 22 economies where financial leasing is specifically regulated, these are rarely used.

FIGURE 2.5 Financial leasing is regulated and used more commonly in East Asia and the Pacific




*Source: Doing Business* database.

**BOX 2.3 Regulation of financial leases in Canada**

In the mid-1990s, Canada's financial services sector was undergoing rapid change. In recognition of this, the government established the Task Force on the Future of the Canadian Financial Services Sector to provide advice on the future of the sector. The Task Force's report was intended to serve as the basis for the next round of revisions to the legislation regulating the sector. The federal Task Force reported that the equipment and vehicle leasing industry was financing $50 billion worth of assets. In this context, the 2001 Financial Leasing Entity Regulations were adopted.[a] Although they did not comprehensively regulate financial leasing in a single instrument, they did include financial leasing entities and the activities they can carry out. In parallel, the government tasked Statistics Canada, the national statistics agency, to collect and publish data on the supply of debt and equity financing to SMEs to better understand their financing needs.

Today, Canada has a well-developed practice of financial leasing which is an important source of external financing for SMEs. Canada's leasing and finance sector felt the effects of the global economic downturn, but the financial leasing industry remains strong. In 2014, more than one-half of Canadian SMEs requested external financing. Financial leasing was the third most widely used source (7.9% of SMEs), after credit financing (29.4%) and debt financing (28.1%)[b] In 2011, it was estimated that 14.9% of SMEs used financial leasing, with requests totaling $102 million, or $48,000 per business.[c] In 2007, the percentage was even higher, with an estimated 22% of SMEs using financial leasing.[d]

The assets leased by SMEs are mainly vehicles (34.6%), machinery and equipment (28.1%) and business or office space (23.6%).[e] Debt financing is also used to purchase machinery or equipment (25.8%), but the main use of debt financing is for working capital (51.3%).[f] It is easier for Canadian SMEs to access financial leasing than traditional loans, as the approval rates are 89.9% for debt financing and 97.4% for lease financing, which equaled $2.5 billion, or $65,000 per business, in 2011.[g] Following Canada's major banks and credit unions, the leasing sector is the largest provider of financing to SMEs and consumers.

a. Financial Leasing Entity Regulations (October 4, 2001)
b. Statistics Canada 2014.
c. Statistics Canada 2013.
d. Statistics Canada 2013.
e. Statistics Canada 2013.
f. Statistics Canada 2013.
g. Statistics Canada 2013.

## CONCLUSION

The secured transactions framework is vital to support SME access to credit. A collateral registry, which records security interests in movable assets, protects the rights of creditors in secured lending, thereby increasing their willingness to provide finance, particularly to SMEs. Globally, however, few economies have collateral registries that follow internationally-recognized good practices, and most economies do not require registration of security rights over movable assets. Establishing modern collateral registries should be explored by economies around the globe.

SME access to finance can be supported by offering alternative financing mechanisms, such as factoring or financial leasing, which can allow firms to access cash faster and under more flexible terms than they could have from a conventional bank loan, regardless of their balance sheet position. However, the costs incurred may be substantially higher than those associated with conventional bank loans.

The data show that there are various degrees of regulation worldwide of factoring and financial leasing. While some economies comprehensively regulate these alternative financing mechanisms, others only reference them. In still other economies, factoring and financial leasing are used in practice despite being mostly unregulated.

## NOTES

[1] Chong, Galindo and Micco 2004.
[2] Berger and Udell 2006.
[3] Love, Martinez Peria and Singh 2013.
[4] Berger and Udell 2006.
[5] Beck, Demirgüç-Kunt and Maksimovic 2008.
[6] Kuntchev and others 2012.
[7] Klapper 2006.
[8] Beck and Cull 2014.
[9] Alvarez de la Campa 2011.
[10] UNCITRAL 2013 and 2016.
[11] Fintrac 2012.
[12] Kozolchyk 2009.
[13] Alvarez de la Campa and others 2010.
[14] OAS 2013.
[15] Safavian, Fleising and Steinbuks 2006.
[16] Alvarez de la Campa and others 2010.
[17] Haselmann, Pistor and Vig 2009.
[18] Haselmann and others 2013.
[19] Bazinas 2013.
[20] Love, Martínez Peria and Singh 2013.
[21] UNCITRAL 2010. Recommendation 54 (j and k): "Registration is effected by registering a notice that provides the information specified in recommendation 57, as opposed to requiring the submission of the original or a copy of the security agreement or other document." The requirements of recommendation 57 are the following: "(a) The identifier of the grantor, satisfying the standard provided in recommendations 58-60, and the secured creditor or its representative and their addresses; (b) A description of the asset covered by the notice, satisfying the standard provided in recommendation 63; (c) The duration of the registration as provided in recommendation 69; and (d) If the State determines that an indication in the notice of the maximum monetary amount for which the security right may be enforced would be helpful in order to facilitate subordinate lending, a statement of that maximum amount."
[22] UNCITRAL 2010. Recommendation 54 (j and k): "The law should ensure that: (j) f possible, the registration system is electronic. In particular: (i) Notices are stored in electronic form in a computer database; (ii) Registrants and searchers have immediate access to the registry record by electronic or similar means, including the Internet and electronic data interchange; (iii) The system is programmed to minimize the risk of entry of incomplete or irrelevant information; and (iv) The system is programmed to facilitate speedy and complete retrieval of information and to minimize the practical consequences of human error."
[23] Fintrac 2013.
[24] UNCITRAL's features of a basic collateral registry can be found in the Guide on the Implementation of a Security Rights Registry (published March 2014) and the Model Law on Secured Transactions (October 2016).
[25] For more information on Mexico's registry, see the website of the Registro Único de Garantías Mobiliarias at https://www.rug.gob.mx/.
[26] Klapper 2006.
[27] OECD 2015.
[28] Magos 2014.
[29] UNIDROIT 1988.
[30] myBusiness. 2016. "Staying Liquid: The Benefits of Factoring for SMEs. https://mybusiness.singtel.com/techblog/staying-liquid-benefits-factoring-smes.
[31] Kraemer-Eis and Lang 2012.
[32] OECD 2015.
[33] Milenkovic-Kerkovic and Dencic-Mihajlov 2012.
[34] Kraemer-Eis and Lang 2012.
[35] OECD 2015.
[36] ECLAC 2011.
[37] Anjali 2005.
[38] UNIDROIT 1988.
[39] The nine economies that have ratified the convention are Belgium, France, Germany, Hungary, Italy, Latvia, Nigeria, the Russian Federation, and Ukraine.
[40] UNIDROIT 1988. According to Article 1(2): "[A] 'factoring contract' means a contract concluded between one party (the supplier) and another party (the factor) pursuant to which: a) The supplier may or will assign to the factor receivables arising from contracts of sale of goods made between the supplier and its customers (debtors) other than those for the sale of goods bought primarily for their personal, family or household use; b) The factor is to perform at least two of the following functions: finance for the supplier, including loans and advance payments; maintenance of accounts (ledgering) relating to the receivables; collection of receivables; protection against default in payment by debtors, c) Notice of the assignment of the receivables is to be given to debtors."

[41] EBRD 2013.
[42] Bakker, Klapper and Udell 2004.
[43] UNIDROIT 2008.
[44] Fletcher and others 2005.
[45] Yan 2006; Slotty 2009; Chigurupati and Hegde 2010.
[46] De Laurentis and Mattei 2009.
[47] Gallardo 1997.
[48] Sharpe and Nguyen 1995.
[49] Fletcher and others 2005.
[50] Lasfer and Levis 1998.
[51] Al Sugheyer and others 2009.
[52] Al Sugheyer and others 2009.
[53] White 2016.
[54] The term "hire-purchase" covers different types of contracts from economy to economy. In some cases, hire purchase involves the transfer of ownership of the asset at the end of the contract, either automatically or through the exercise of a purchase option. These types of hire-purchase contracts are therefore leases (this is the case in Germany, the Netherlands, Poland and the United Kingdom). However, in cases where ownership transfers at the beginning of the contract, these types of contracts are closer to an instalment credit contract than a lease.
[55] White 2016.
[56] White 2016.

# Improving Access to Finance for SMEs through Insolvency Practices

An economy's insolvency framework is a critical element of its financial infrastructure. Insolvency laws regulate the exit of firms from the market and make resolution of multiple creditors' conflicting claims more orderly. As the rate of failure for SMEs is higher than for larger firms, general wisdom holds that insolvency frameworks play a crucial role in the SME lifecycle. The soundness of the overall insolvency framework also plays a vital role in the lending process. This report also describes three insolvency mechanisms used by different jurisdictions to improve SME lending. The conclusions about their effectiveness are less clear. SME-targeted mechanisms work well in some economies, but in others—particularly where they were recently introduced, are not commonly used by insolvency practitioners or are not yet fully implemented—they are less effective. The first section presents findings from previous studies that empirically demonstrate the importance of a good insolvency framework in the lending process. The second section presents three SME-friendly insolvency mechanisms and discusses their implementation around the world. The final section discusses global data collected for this report to assess the effectiveness of SME-friendly mechanisms.

## IMPORTANCE OF INSOLVENCY FRAMEWORK IN THE LENDING PROCESS

The default recovery rules that form part of an economy's insolvency framework influence the lending decisions of creditors (banks, in particular). A recent study of 2,280 distressed SMEs in France, Germany and the United Kingdom explored whether insolvency laws factor into predicting the outcome of financial distress.[1] The study finds that creditor recovery rates can vary greatly depending on the insolvency framework and that banks adjust their lending and reorganizational practices to reflect the strength of an economy's insolvency framework. In France, for example, insolvency law provides limited protection to secured creditors. As a result, banks in France require higher levels (and different types) of collateral than banks in Germany and the United Kingdom.

A study of Italian insolvency reforms in 2005 and 2006 confirmed that insolvency laws influence credit availability and conditions.[2] Using loan-level data collected by the central bank—including information on 226,422 loan contracts and 100,000 credit lines issued by 94 banks to 35,041 Italian manufacturing SMEs between 2004 and 2007—the study found that the introduction of a new restructuring procedure increased the amount of restructured credit by 500 million euros ($613 million) in 2007 alone, thus expanding credit availability. Also, improvements to the liquidation process decreased the cost of bank financing, resulting in a savings of 130 million euros ($159 million) per year in total interest paid by SMEs.

A comparative study in Brazil that looked at whether the 2005 Brazilian insolvency reform had impacted the terms of contractual debt (cost of debt, short-term debt, long-term debt and total debt) had similar findings. Firm-specific fiscal-year accounting data for 698 publicly-traded firms in Brazil (the treatment group) were compared to firm-level data from Argentina, Chile and Mexico (the control group).[3] The findings show that, while the reform reduced the cost of debt, it drove an increase in both long-term debt and total debt; no effect on short-term debt was observed.

The role of insolvency laws in facilitating the resolution of NPLs, particularly in the wake of the 2008 financial crisis, is the focus of several other studies. The share of non-performing loans (NPLs) in the banking sector is a measure of financial sector soundness and is an important factor in credit supply. One study explored the impact of insolvency laws—in particular, the availability of restructuring mechanisms—on the levels of NPLs in Europe. The study, which looked at the quality of insolvency regulations in the EU Member States (taking into account different types of restructuring mechanisms), showed a positive association between the quality of insolvency regulation that facilitates debt restructuring and an improvement in NPL ratios.

Despite the importance of insolvency rules in the lending process and in dealing with NPLs, most insolvency frameworks are not well-suited for dealing with SME loans. Insolvency laws typically include complex rules for addressing multiple creditor claims and anticipate the active participation of creditors, as well as considerable involvement by the judiciary. All of these aspects require the specialized knowledge of experienced legal professionals, as well as a significant time commitment and financial resources. However, SMEs are typically small-scale operations with a limited number of creditors and limited assets. When SMEs experience financial difficulties, they often lack the resources and know-how to navigate complex insolvency frameworks. Furthermore, creditors, especially banks, have little interest in investing resources in restructuring SMEs, even when they are viable.

Several SME-friendly insolvency mechanisms have been developed to address the shortfalls of traditional insolvency laws. First, out-of-court workouts—either with limited or no judicial participation—are more informal and faster than formal insolvency proceedings. Second, pre-insolvency proceedings, can address financial distress before it leads to insolvency. Finally, specialized insolvency proceedings—often with fast-track timelines, simplified rules and lower fees—can assist debtors with a limited number of creditors and with limited resources.

The following sections detail these three mechanisms and provide examples of their implementation in different economies. The discussion uses *Doing Business* data obtained through a questionnaire administered to legal experts, insolvency practitioners and judges in 190 economies, as well as available literature.

## OUT-OF-COURT WORKOUTS

The 2008 global financial crisis resulted in a large number of companies—including many SMEs—facing defaults and illiquidity, which drove an increase in NPLs. During the crisis, the vulnerabilities and inadequacies of insolvency procedures in many economies became evident; the courts were overburdened, and insolvency regimes lacked the capacity for voluntary restructuring.[4] Judicial insolvency procedures were time-consuming and expensive, either reducing the value of the company (in the case of judicial reorganizations) or preventing an efficient reallocation of assets (in the case of in-court liquidations).[5] These issues prompted some economies to implement alternative methods of asset resolution as a solution to corporate indebtedness.

One of these alternative methods is the out-of-court workout (OCW). OCWs refer to debt restructuring that involves a multilateral contractual agreement with creditors to change a debtor's composition of assets and liabilities without judicial intervention. OCWs are used to ensure rapid recovery for distressed companies through a voluntary agreement (compromise) between the distressed company and its creditors.[6] An OCW may involve debt rescheduling, reduction of interest rates, total or partial write off of debt, or even new loans.[7] For the purposes of this section, out-of-court workouts refer to debt restructuring that involves changing the composition and/or structure of assets and liabilities of a debtor in financial difficulties without resorting to a full judicial intervention. Out-of-court workouts are used to ensure rapid recovery for distressed companies through a voluntary agreement (compromise) between the distressed company and its creditors.

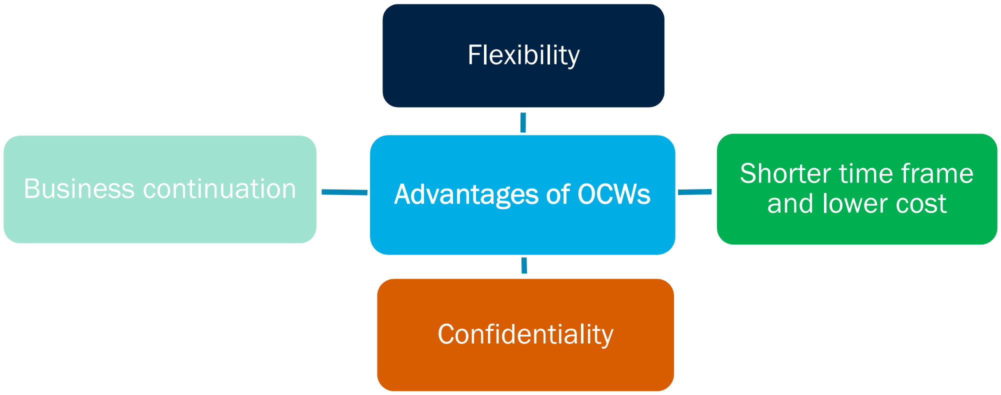
The OCW process is informal and can be started by any party. Typically, during the OCW procedure, the main financial creditors are involved in negotiations, and a lead creditor is appointed—together with a creditors committee (steering committee)—to provide leadership and coordination. The OCW process includes a defined negotiating period (through a standstill agreement); during this period, the debtor's management remains in control. An OCW may include the operational restructuring of the business or the financial restructuring of its liabilities; it can be used as (i) an alternative to the formal insolvency proceedings, (ii) to complement formal insolvency proceedings or (iii) as part of the process in hybrid procedures.

The objective of the OCW process is to prevent the liquidation of viable companies by providing a flexible and informal mechanism for banks to negotiate a business rescue plan with the debtor—in cases where the business is viable—and to preserve the value of the company, allowing it to continue operating and ensuring a higher rate of creditor repayment. OCWs represent an effective means of resolving insolvency because they are less expensive and less time consuming than a formal judicial insolvency proceeding.[8]

The World Bank Principles for Effective Insolvency and Creditor Rights Systems and the UNCITRAL Legislative Guide on Insolvency Law[9] highlight the importance of OCWs as an essential part of an efficient creditor-debtor regulatory system. World Bank Principle B3 establishes that corporate workouts should be supported by an enabling environment, one that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability. An informal out-of-court restructuring procedure has four main advantages: (i) flexibility to the specific needs of the debtor's business; (ii) a shorter time frame and lower cost than formal insolvency proceedings, resulting in a better negotiating environment; (iii) confidentiality and protection of the debtor's reputation; (iv) business continuation, making it easier for the debtor maintain control of their business (figure 3.1).[10]

OCWs were first promoted in the mid-1970s when the United Kingdom was on the verge of a systemic economic crisis due to an industrial recession. Commercial banks were experiencing high levels of NPLs, many companies were under financial stress, and the insolvency regime lacked effective mechanisms for voluntary restructuring. As a consequence, the Bank of England (the central bank) intervened by implementing a series of agreements between debtors and banks aimed at rehabilitating distressed firms that were potentially viable and to achieve coordination and cooperation among creditors.[11] These informal arrangements, became known as the London Approach,[12] and were conceived as a set of principles for voluntary workouts, providing general guidance to banks, companies and other creditors on how to proceed when facing financial rehabilitation.[13] The purpose of the London Approach was to facilitate the restructuring of viable companies through four guiding principles: (i) lending banks will not exercise their rights to initiate official insolvency process; (ii) any decision made will be based on reliable information that must be shared among all the lending banks and that remains confidential; and (iii) banks will work together to try to form a collective view on whether support for the debtor should continue and, if so, in what form; and (iv) all lending banks will share the burden of supporting the debtor equally.[14] The objective of the London Approach was to minimize the financial losses to banks stemming from company failures through coordinated and well-prepared workouts, avoid unnecessary liquidations of viable companies through reorganization and prevent immediate failure by providing interim financial support.[15]

FIGURE 3.1 Advantages of Out-of-Court Workouts




The success of the London Approach inspired the use of OCWs in many economies which adopted similar mechanisms.[16] Economies including Indonesia, Malaysia, the Republic of Korea and Thailand implemented out-of-court negotiations, adopting variants of the London Approach with customized solutions applicable to their specific jurisdictions to restructure companies in financial difficulties during the 1998-2001 Asian crisis.[17] The financial restructuring of Asian companies during the crisis was resolved mainly by the adoption of OCW procedures facilitated by government institutions and debtor-bank relationships.[18] Malaysia, for example, established the Corporate Debt Restructuring Committee (CDRC) in 1998 with the support of the Bank Negara Malaysia to provide a forum and framework for creditors and debtors to reach voluntary agreements. The CDRC was formed to provide a platform for financial institutions and corporate borrowers to work out possible debt restructuring schemes amicably and collectively without resorting to legal proceedings.[19]

Inspired by the London Approach, in 2000 the International Association of Restructuring, Insolvency and Bankruptcy Professionals (INSOL) developed a global approach to multi-creditor workouts by issuing a statement of Principles for a Global Approach to Multi-Creditor Workouts (known as the INSOL principles).[20] The following are the areas covered by the INSOL statement:

i. Parties should agree on a standstill period, during which the debtor prepares a proposal for resolving its financial difficulties.
ii. During the standstill period, creditors agree to take no action against the debtor and distribution priorities remain unchanged.
iii. During the standstill period, the debtor should not take any action which might adversely affect the prospective return to creditors.
iv. Creditor should coordinate their positions, for example via committees or professional advisers.
v. Debtor should provide creditors and advisers with timely relevant and information about its financial situation.
vi. Proposals should reflect the applicable law and relative positions of relevant creditors.

vii. Information provided by the debtor should be treated as confidential and should be available to all creditors.
viii. If additional funding is provided during the standstill period, it should be repaid first.

The INSOL principles are considered indicative of good practice on multi-creditor OCWs and are commonly used as a starting point in designing country-specific guidelines.[21] Since the development of the INSOL principles, many economies have implemented reforms to their insolvency frameworks, establishing OCWs with adaptations and variations, with the aim of providing effective and efficient corporate informal restructuring mechanisms.

*HOW DO OUT-OF-COURT WORKOUTS BENEFIT SME LENDING?*

Bankruptcies are viewed as a last resort to preserve viable firms in financial distress. However, when dealing with insolvency or financial distress, SMEs face different legal, regulatory and financial constraints than large corporations. OCWs can meet the needs of SMEs by reducing the expenses associated with litigation, cutting the time required to ease corporate distress and easing the uncertainty surrounding adverse outcomes. Where regular insolvency costs are prohibitive to an SME, a viable distress firm may be preserved if an effective OCW process in place.

There are many reasons why firms opt to undertake OCWs instead of commencing formal insolvency procedures, including the complexity and rigidity of the insolvency regime, the length of procedures and the high cost of professional counsel. Additionally, SMEs have specific features that discourage them from entering formal insolvency procedures. For example, lending to SMEs is typically secured by real estate; when banks commence enforcement procedures, small firms cannot effectively restructure their financial debt to protect their economic value. Also, SMEs are typically owned by families that have guaranteed the business loan with their personal assets; this can result in overlapping personal and business insolvency procedures. As such, OCWs are a suitable alternative to formal insolvency proceedings for SMEs.

By allowing the management to remain in control of the debtor's assets, OCW procedures also provide less interference in the day-to-day activity of SMEs and promote business continuation. SMEs are typically administrated by specialized managers or the owners themselves; a change in the management structure may generate business uncertainty and disrupt the firm's relationship with suppliers and customers.

Out-of-court workouts can also support the financial relationship between borrowers and creditors. Large firms have a greater ability to access new funding after the start of standard in-court insolvency procedures than SMEs. For a small company, preserving lender confidence may be more important. Rather than start an insolvency procedure that could, in fact, increase a SME's bad debts, an OCW can provide an opportunity to further develop relationship between debtor and creditors through mutual cooperation.

*HOW OFTEN ARE OCWs USED IN PRACTICE?*

Of the 153 economies measured by the Improving Access to Finances for SMEs project, the insolvency framework in only 31 economies provides for a specific and well-defined legal framework or legally-binding guidelines for OCWs. A large proportion of these economies are OECD high-income economies (45%), including Australia, Belgium, France, Japan, Latvia and the United Kingdom. The remainder is distributed between East Asia and the Pacific (16%), Latin America and the Caribbean (16%), Europe and Central Asia (16%) as well as South Asia (3.3%) and Sub-Saharan Africa (3.3%). However, across different economies, regulations governing OCWs varies in their application and scope. Hybrid voluntary restructuring regulations are in place in some economies, with features that are typical for OCWs, but with tailored elements that go beyond the standard definition referred to above. In the United States, for example, where the insolvency framework does not specifically regulate out-of-court workouts, in practice the bankruptcy courts encourage workouts in cases where the parties' interest might be better served by such mechanisms.

The most common feature of the legal framework for out-of-court workouts is a standstill period when creditors cannot enforce their claims. The standstill period is found across economies from all regions and income levels, including as Chile, Greece, India, Macedonia, New Zealand, the Philippines and South Africa. The second most common feature is a good faith negotiation requirement, which is present in economies such as Malaysia and Uruguay. Finally, a feature commonly used across different economies is a recommendation to disclose all relevant information (for the debtor and creditors). It is noteworthy that in 14 economies of the 31 where a defined OCW framework is present, out-of-court workouts must be sanctioned or ratified by a court or an administrative agency to be binding.

Despite the benefits of having a clear regulatory framework governing voluntary restructuring, the use of out-of-court workouts remains rare in practice. Out-of-court workouts are regularly and frequently applicable in practice in only 14 economies. These economies are Australia, Belgium, Colombia, France, Greece, Guatemala, Italy, Japan, Latvia, Malaysia, the Philippines, the Republic of Korea, South Africa, and the United Kingdom.

BOX 3.1 Out-of-court workouts in Latvia

In response of one of highest levels of indebtedness in Europe [a]., the Latvian authorities designed a strategy which included the implementation of voluntary debt restructuring mechanisms such as out-of-court workouts

A Consultative Committee was established, made up of representatives from the Ministry of Justice, the state “Insolvency Administration,” the Latvian Commercial Bank Association, Latvian Certified Insolvency Process Administrator Association, the Latvian Labor Confederation, the Foreign Investor’s Council in Latvia, the Latvian Chamber of Commerce and Industry, and the Latvian Borrower's Association.

The Consultative Committee approved voluntary out-of-court settlement guidelines in August 2009. The guidelines provided a set of high-level practices, based on the INSOL principles, modified to fit the Latvian insolvency framework. The guidelines were published on the website of the Ministry of Justice.[b] The government organized workshops and training to increase awareness of the guidelines among stakeholders (banks, insolvency practitioners) and promote their use.

Latvia's top banks identified the OCW guidelines as pivotal in addressing the widespread debt distress in the corporate sector caused by the financial crisis. Based on information from the Financial and Capital Market Commission (FCMC), most banks in Latvia have incorporated these guidelines into their internal procedures and creditors and debtors can now agree more easily to change the terms of debt repayments, allowing debtors to continue to do business without initiating insolvency proceedings in court. Resources have been freed up in the court system as a result. The OCW also allow creditors and debtors to address collective action problems through the provision of standstills or moratoriums and they can encourage transparency and good faith in negotiations.

a.Erbenova and others 2011
b.Latvia, Ministry of Justice. "Guidelines for Out-of-Court Debt Restructuring in Latvia." https://www.tm.gov.lv.

PRE-INSOLVENCY PROCEEDINGS

One of the more comprehensive definitions of pre-insolvency proceedings can be found in Regulation (EU) 2015/848 of the European Parliament. Article 1 describes pre-insolvency proceedings as *"public collective proceedings, including interim proceedings, which are based on laws relating to insolvency and in which, for the purpose of rescue, adjustment of debt, reorganization or liquidation: (a) a debtor is totally or partially divested of its assets and an insolvency practitioner is appointed; (b) the assets and affairs of a debtor are subject to control or supervision by a court; or (c) a temporary stay of individual enforcement proceedings is granted by a court or by operation of law, in order to allow for negotiations between the debtor and its creditors, provided that the proceedings in which the stay is granted provide for suitable measures to protect the general body of creditors, and, where no agreement is reached, are preliminary to one of the proceedings referred to in point (a) or (b)."*[22]

Although there is no single definition for pre-insolvency proceedings across economies, the elements mentioned in EU Regulation 2015/848 are commonly found in various jurisdictions. Pre-insolvency proceedings aim to restructure firms before they become formally insolvent. They are typically governed by insolvency laws and regulations and involve a judicial or administrative authority, most often a court. Indeed, sanctioning by a court (or an administrative authority) is one of the main features of pre-insolvency proceedings. Another is the binding effect of arrangements reached during insolvency proceedings vis à vis minority creditors. Once an arrangement is approved by a qualified majority of the affected class or classes of creditors, all creditors within the class (or classes) become bound by it, even if they voted against it. This feature separates the pre-insolvency proceedings, from OCWs, where only creditors who agree to the workout are parties to it.

Also, as referenced in the EU Regulation, a restructuring moratorium forms part of pre-insolvency proceedings in certain legal systems. The purpose of the moratorium is to temporarily suspend certain creditors rights, such as the right to enforce a security, file a claim for recovery of a debt or request that insolvency proceedings be opened. However, effective pre-insolvency legislation specifies short suspension periods, strict conditions to extend those periods and a clear position on creditors' rights. The moratorium is similar to the standstill period of the OCWs, however, while the standstill period refers to a voluntary agreement between creditors and the debtor, a moratorium is legally mandated. In general, pre-insolvency proceedings fall somewhere between a hybrid of out-of-court rehabilitation and formal rehabilitation procedures. For the purposes of this section, pre-insolvency proceedings are defined as collective proceedings under the supervision of a court or an administrative authority, which give a debtor in financial difficulties the opportunity to restructure at a pre-insolvency stage and to avoid the commencement of formal insolvency proceedings in the traditional sense.

In France, two types of consensual private and one type of public pre-insolvency proceedings are available to debtors that are not cash-flow insolvent. The two types of consensual private pre-insolvency proceedings are the mandatory ad hoc and conciliation proceedings—both are confidential and subject to non-disclosure conditions. The public proceeding (also known as the safeguard proceeding) triggers both a stay of payments and an obligation to maintain existing contracts.

In some economies, pre-insolvency proceedings are not adequately regulated or are not regulated by insolvency laws There is no comprehensive standard for good practices, so each economy adopts slightly different mechanisms. Variations between pre-insolvency procedures across economies can make cross-border enforcement difficult, resulting in financial losses for creditors and shareholders (particularly in terms of sub-optimal debt recovery) and hampering the reorganization efforts of groups of companies with subsidiaries in other jurisdictions.[23]

*HOW DO PRE-INSOLVENCY PROCEEDINGS BENEFIT SME LENDING?*

To increasing the likelihood of successful restructuring, efficient pre-insolvency frameworks are associated with higher levels of entrepreneurship and positive impacts on financial stability and economic activity. Including pre-insolvency proceedings in insolvency frameworks plays a crucial role in fostering a culture of early restructuring and second chance that encourages economic agents to be entrepreneurial and take sound economic risks. Moreover, this type of proceeding speeds up deleveraging and eases economic adjustment costs for both households and firms. With regards to the impact on entrepreneurship, the efficiency of the rescue and recovery framework is found to have a significant positive impact on self-employment rates. Inefficient pre-insolvency proceedings, on the other hand, slow deleveraging, delaying loss recognition and impeding credit flows to solvent corporations and individuals. That is why it is crucial that pre-insolvency proceedings are designed and implemented in a way to foster early detection of financial distress and provide effective tools for addressing it. Otherwise, they may end up delaying the formal insolvency process.

A study conducted by the European Commission on the economic impact of pre-insolvency proceedings on entrepreneurship in the EU Member States found that a lack of restructuring tools—particularly at the pre-insolvency stage—resulted in the reduced efficiency of the insolvency framework overall and lower chances of restructuring. Indeed, the high cost and complexity of pre-insolvency proceedings and lack of incentives to file early (before the debtor becomes formally insolvent) decreases the efficiency of the insolvency framework among member states.[24]

*HOW OFTEN ARE PRE-INSOLVENCY PROCEEDINGS USED IN PRACTICE?*

Pre-insolvency proceedings are not commonly used in practice. Furthermore, there are few success stories when they are used. For example, although many European economies allow debtors to temporarily suspend payments or pay only the most important creditors at the pre-insolvency stage—allowing them time to find a viable solution to their financial problems—in Belgium 70% of firms that initiated a pre-insolvency restructuring proceeding were declared bankrupt within the following two years.[25]

Specific regulation on pre-insolvency proceedings does not exist in the United Kingdom; instead, the instrument of administration provides for the possibility of company restructuring and rescue. Pre-insolvency proceedings in the United Kingdom are commenced without court involvement and, as a result of the lack of regulation in this area, creditors cannot object to these decisions.[26]

In the 17 member states of the Organization for the Harmonization of Business Law in Africa, known by its French acronym OHADA, the Uniform Act on Insolvency introduced three procedures, one of which is designed to offer businesses facing financial difficulties a means of pre-insolvency rescue (*réglement préventif* or conciliation).[27] Conciliation is a pre-insolvency proceeding used to avoid the cessation of payments by the debtor and allow the company to keep operating.[28] However, these procedures are rarely used, and the law has remained at this stage without practical application.

Pre-insolvency proceedings are available to all companies in only 30 economies (across all regions and income levels). In most economies, the legal framework does not differentiate the type of company when regulating pre-insolvency proceedings. Other economies have established specific conditions. In Croatia, for example, the law states that the court must reject a pre-bankruptcy procedure proposal from a firm for which less than two years have passed since the fulfillment of the debtors' obligation of the previous pre-bankruptcy settlement.

In 45 economies a judicial court or administrative agency supervises pre-insolvency proceedings. In the OHADA economies, the jurisdiction for preventive proceedings is the same as the one for regular collective proceedings. A similar approach is found in Honduras and Vietnam, where the court with the jurisdiction to conduct pre-insolvency preventive procedures is the same as that which conducts bankruptcy procedures. It is a common feature in Latin American economies that this jurisdiction is assigned to an administrative agency. In Chile, the Superintendency of Insolvency oversees pre-insolvency proceedings while, in Peru, the Insolvency Procedures Commission (INDECOPI) oversees these procedures. In the Dominican Republic, the Ministry of Commerce and the Chamber of Commerce have authority to conduct pre-insolvency proceedings.

BOX 3.2 Pre-insolvency in the Middle East and North Africa

Few economies in the Middle East and North Africa have pre-insolvency proceedings in place to allow firms to avoid bankruptcy. In Oman, however, the insolvency law includes provisions for an insolvency proceeding to be concluded by a preventive composition or scheme of arrangement with creditors where it is deemed by the court to be in the public interest or the interest of the debtor or the creditors. The debtor can approach the court to request an extension in which to improve the financial status of the company at the pre-insolvency stage. Similarly, chapter 5 of the Lebanese Code of Commerce provides for a simple process of conciliation (*concordat préventif*) between the debtor and the creditors as a result of which a debtor may enter into “a scheme of arrangement in avoidance of bankruptcy.” Article 459 provides that the debtor may petition the court to reorganize its debts. Under this Article, any merchant—before entering a state of insolvency or within ten days following such state—may initiate a pre-insolvency procedure by requesting that the Tribunal of First Instance convene its creditors and propose to them a pre-insolvency arrangement. Upon the failure of the scheme, the court will make a bankruptcy order against the debtor. The amicable settlement procedure is also possible in Morocco. However, similar to the OHADA economies, pre-insolvency proceedings in the economies of the Middle East and North Africa region are rarely, if ever, used.

Although many economies include pre-insolvency proceedings in the legal framework, they are not commonly used in practice. In fact, only 18 of the 153 economies measured in our sample reported the use of such proceedings in practice. In Croatia, the pre-bankruptcy procedure is commonly used. In Spain refinancing agreements were introduced in 2015 and, since then, a rising number of them have been judicially sanctioned. If unchallenged, the refinancing agreement can be a flexible tool (as it does not require much judicial oversight) that allows the debtor to achieve a settlement of liabilities in a short period.

The most common feature of pre-insolvency proceedings is the ability of a debtor to initiate the proceedings as opposed to regular insolvency proceedings that can be initiated by the creditor as well (this is the case in 16 economies in our sample). The next most-common feature is that debtors/administrators can propose a compromise agreement, the benefits of a moratorium on debt enforcement and the fact that the debtor remains in control of the business (14 economies).

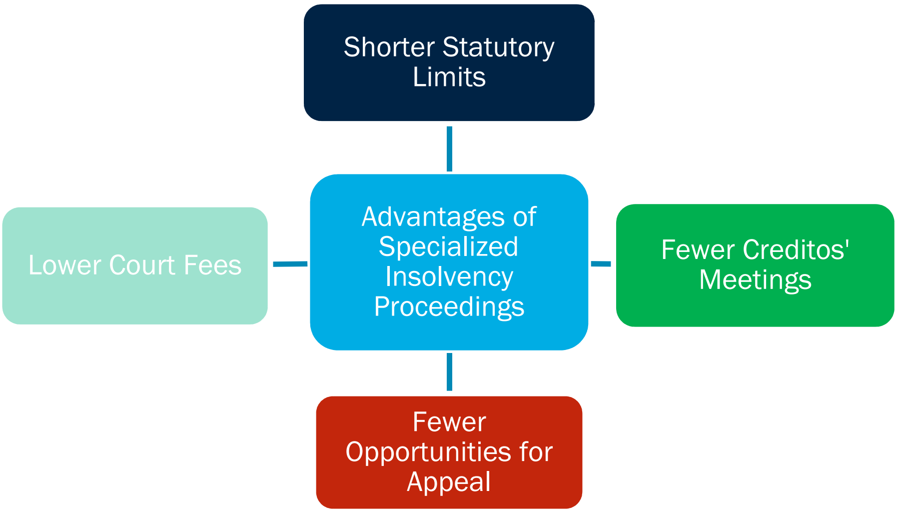
## SPECIALIZED INSOLVENCY PROCEEDINGS

In-court corporate insolvency procedures are of paramount importance for economic growth and market stability. They allow viable businesses to be successfully preserved or efficiently closed while helping creditors achieve maximum value of their assets. However, insolvency procedures can be complicated, time-consuming, costly and with very rigid structures.[29] In many cases, by the time the debtor company (or their creditors) initiates insolvency proceedings, the firm is no longer viable, which results in loss of value, compromising the preservation of the company at the expense of legal procedural certainty, including the protection of the creditors' rights.[30]

A recent insolvency reform trend is the establishment of specialized insolvency proceedings that may reduce the risk of firm disappearance by enabling targeted, expedited and simplified judicial debt restructuring or liquidation procedures.[31] Many economies have begun to implement streamlined, flexible and accessible insolvency mechanisms by customizing procedural rules and decreasing the burden on firms compared to ordinary insolvency proceedings without jeopardizing the necessary creditor safeguards.[32]

Eligibility and access to specialized insolvency proceedings may be based on corporate characteristics, such the form of company incorporation, the type of business activity, the value of company assets and liabilities or the number of creditors and employees. The goal is to identify debtors who may benefit from a different procedural mechanism than regular insolvency proceedings. Typically, specialized proceedings can also be referred to as simplified proceedings and offer various procedural advantages, such as shorter statutory limits, fewer creditors' meetings, limited court appearances, fewer opportunities for appeal, less judicial oversight and lower court fees (figure 3.2).

FIGURE 3.2 Advantages of specialized insolvency proceedings




*HOW DO SPECIALIZED PROCEEDINGS BENEFIT SME LENDING?*

Insolvency laws and regulations are designed to allow a debtor and its creditors to interact and appropriately resolve a situation of financial distress. Most insolvency laws are designed to accommodate large companies; using the same insolvency procedures when the firms are SMEs can generate inefficiencies. For example, the complexity and length of regular insolvency procedures may discourage SMEs from filing. When dealing with insolvency, SMEs face many obstacles and constraints. For example, SMEs often lack the financial resources to cover the legal expenses associated with formal insolvency proceedings (such as hiring an insolvency professional or paying court and attorney's fees, compiling documents, and interacting with creditors). Due to opaque financial information (as discussed in chapter 1), small firms may find it extremely difficult to secure new operating capital (from either existing or new creditors) once insolvency proceedings have commenced. In seeking alternative sources of financing, SMEs often choose not to initiate insolvency procedures, which, in the long term, further reduces the chance of business survival. At the same time, SME insolvency cases may not generate enough incentive for creditors' participation—the return that creditors can expect to receive is simply not high enough to justify the cost of their participation. As a result, SMEs in financial difficulties often continue operating to the point of failure without seeking rehabilitation or taking advantage of any of the insolvency procedures available, resulting in lost investments.

When SMEs fail, the debtor, creditors, employees and other involved parties lose. SME collapse as a result of financial difficulties may, subsequently, deter lenders from extending credit to other SMEs, as the risk of lending is too high. One way to mitigate these risks and encourage orderly restructuring and market exit is by offering SMEs an insolvency regime tailored to their needs, such as specialized SME-specific or fast-track insolvency proceedings.[33]

*WHAT ARE THE FEATURES OF SPECIALIZED PROCEEDINGS?*

More and more economies are introducing specialized insolvency proceedings as part of their insolvency law reform. Although research in this field is limited (and further study is warranted), the available literature suggests that in implementing SME-specific insolvency proceedings, governments should focus on features such as accessibility requirements, flexible commencement standards, streamlined methods of creditor participation and fast-track mechanisms (shorter delays) and reduced costs in each procedural phase.[34]

The specialized proceedings mechanisms should also be balanced, with incentives for both debtors and creditors. Incentives for debtors can include the availability of a moratorium—so that creditors cannot enforce their claims outside of the insolvency process—and allowing the debtor to remain in control of business operations. Incentives for creditors can include flexibility in negotiating a settlement (reorganization plan) and achieving a better return by preserving the debtor's business (which in regular insolvency procedures might have ceased operations).[35]

Economies that have implemented reforms in this area have adopted one of two approaches. The first approach is to rely on the general insolvency framework and create exceptions in certain procedural steps for simple claims to make the insolvency framework more efficient and less costly. The second approach is to adopt a new insolvency regime explicitly tailored to the needs of SMEs.

Japan and the Republic of Korea opted to implement specialized insolvency proceedings for SMEs. The SME insolvency regime in Japan differs from ordinary insolvency proceedings by offering a shortened timeline, specific rules for eligibility and commencement and more flexible requirements for proof and objection of claims. Other jurisdictions (Argentina, Germany and Greece, for example) have adopted exceptions to their insolvency legislation that apply to "small cases." In Argentina, for example, the formation of a creditors' committee is not mandatory in cases with fewer than 20 unsecured creditors for firms with less than 20 employees (this is a requirement in regular insolvency proceedings). In Greece, debtors with assets of less than 100,000 euros ($123,000) are eligible to commence simplified procedures with an expedited process for verification of creditors' claims.

The OHADA economies implemented a unified insolvency regime that introduced a simplified reorganization proceeding for small companies.[36] Under this fast-track procedure, a reorganization plan must be decided within two months; there is no requirement to organize a general meeting of creditors or for the judge to supervise every step of the process and there is no possibility for an appeal.

*HOW OFTEN ARE SPECIALIZED PROCEEDINGS USED IN PRACTICE?*

Of the 153 economies measured, 29 provide for a simplified (or fast-track) in-court liquidation procedure; it is used in practice only in seven economies. Simplified in-court reorganization proceedings are present in the legal frameworks of 31 economies, but these are only used in practice in seven economies.

In Argentina, simplified in-court liquidation procedures are often used in practice by companies with less than 20 workers or with obligations of less than less than 100,000 Argentine pesos ($5,000) or less than 20 unsecured creditors. In Hong Kong SAR, China—where this type of procedure is also widespread—the receiver outsources company liquidation cases with assets under 200,000 Hong Kong dollars ($25,400) as stipulated under Section 194(1A) of the Companies (Winding Up and Miscellaneous Provisions) Ordinance. In France the simplified liquidation procedure is available to a business provided its assets do not include immovable property and the number of its employees and its turnover is below a set threshold. The procedure is shorter and simpler, especially regarding the verification of claims and the sale of property. Simplified liquidation procedures are also common in Greece, Japan, the Netherlands, Niger, Poland and Uruguay, among others.

Simplified in-court reorganization procedures are available in economies across all regions and income levels (for example, Brazil, Cameroon, Canada, Greece, Italy and Lithuania). In Spain, under Article 191 of the Insolvency Law, a judge may opt for a simplified procedure when a case is deemed to be relatively simple (that is, it involves less than 50 creditors, the estimated liabilities do not exceed 5 million euros ($6.1 million), and the valuation of the assets and rights is less than 5 million euros). In Slovenia, a simplified compulsory settlement procedure is available to micro and small firms and sole entrepreneurs.

The data show that firm size is the primary motivation for companies to apply for simplified (fast-track) in-court proceedings. In most of the economies included in this study, SMEs benefit from the thresholds established in the legal framework as commencement standards for simplified (fast-track) in-court proceedings. In OHADA economies, for example, the Uniform Act stipulates that simplified liquidation is available to small companies with no real estate assets; simplified reorganization is available to small companies. However, the debtor must be insolvent. Only 45 economies—mostly in the European Union and OHADA—define SMEs as part of the insolvency framework.

Finally, the fact that simplified (fast-track) proceedings differ from regular insolvency proceedings by establishing lower procedural requisites is also acknowledged by contributors as a procedural incentive. In economies like Finland, simplified (fast-track) proceedings are becoming commonly used mainly because the obligation to announce the commencement of the proceedings publicly can be avoided. Most importantly, fast-track confirmation of the restructuring plan is possible, meaning that most court procedures can be avoided.

BOX 3.3 The case of France

In France, a simplified liquidation procedure is available for small companies with no real estate assets. The court must trigger this procedure if the business is experiencing financial distress, has only one employee and a turnover that does not exceed 300,000 euros ($368,000). For companies with two to five employees and a turnover between 300,001 and 750,000 euros, the procedure is optional and can be ordered by the court.

In simplified liquidation, the liquidator does not need approval from the judge to sell the debtor's assets and must perform the sale within three months of commencement. Also, only potential priority ranking claims and wage claims are checked in the process. Finally, the procedure must be completed within one year of the commencement decision.

The French legal framework only provides for simplified in-court proceedings applicable to liquidations. There is no regulation of simplified procedures in court for reorganization cases. The main criteria for companies to apply for simplified in-court procedures is the size of the company (it must be a SME) and the advantages of shorter statutory time limits and fewer opportunities for extension of time.

## CONCLUSION

The insolvency framework is a critical component of the lending process. Credit availability and conditions are influenced by insolvency laws as they regulate the exit of firms from the market and make resolution of multiple creditors' conflicting claims more orderly. Despite a higher failure rate for SMEs compared to larger firms, the time and cost of insolvency proceedings may discourage unprofitable SMEs from going to court, resulting in their continuing operation and eventual disappearance.

A recent insolvency reform trend is the establishment of insolvency mechanisms specifically designed to reduce the risk of SME disappearance. In implementing alternative and creative methods of asset resolution, sustainable solutions to SME indebtedness have been established. However, SME-specific practices may work in some economies, but not in others. The main issue is that in many jurisdictions such mechanisms have been only recently introduced and have not yet become commonplace or have yet to be fully implemented.

One SME-specific insolvency practice, the out-of-court workout, is a flexible mechanism used to negotiate a multilateral contractual agreement with creditors to change a debtor's composition of assets and liabilities without judicial intervention, thereby preventing the liquidation of a viable firm. Some economies have established OCWs based on the INSOL principles, establishing a global approach to multi-creditor workouts. Despite the advantages of OCW mechanisms in facilitating lending to insolvent SMEs, the data indicate that very few economies have implemented specific OCW regulation frameworks and that the mechanism is rarely used in practice in most jurisdictions.

Pre-insolvency proceedings are aimed at restructuring businesses before they become formally insolvent. Such procedures involve a judicial or administrative authority—most often a court—and the binding effect of arrangements reached during the proceeding. In many economies, despite providing an additional mechanism to address financial distress early, pre-insolvency proceedings are not commonly used in practice. However, in economies where pre-insolvency proceedings are used, the treatment of contracts is the key element when embarking on this type of proceeding.

The establishment of specialized insolvency proceedings—expedited and simplified judicial debt restructuring or liquidation procedures target to firms of specific size or market——is another recent insolvency reform trend. While this type of mechanism has been implemented across economies in all regions, the data show that it is actually used in practice in few economies.

## NOTES

1 Davydenko and Franks 2006.
2 Rodano and others 2015.
3 Araujo and others 2012.
4 Nigam 2016.
5 McGowan and Andrews 2016.
6 Garrido 2012.
7 Davydenko and Franks 2006.
8 Araujo and others 2012.

[9] For more information on out-of-court workouts, see pages 21-26 of UNCITRAL's Legislative Guide on Insolvency Law available at http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf.
[10] Araujo and others 2012.
[11] Lieberman and others 2005.
[12] In 1996 the British Bankers Association defined the London Approach as "a non-statutory and informal framework for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring."
[13] Rodano and others 2015.
[14] Flood 1995.
[15] Kent 1997.
[16] Laryea 2010.
[17] Kawai and Schmiegelow 2013.
[18] Cumming 2015.
[19] Garrido 2012.
[20] For more information, see INSOL's Statement of Principles available from http://www.insol.org/page/57/statement-of-principles.
[21] Kargman 2011.
[22]Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, available from https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32015R0848.
[23] European Commission 2012.
[24] Carpus Carcea and others 2015.
[25] CMS Legal Services EEIG 2014.
[26] Goudzwaard 2014.
[27] Omar 2000.
[28] For more information, see Articles 5-1, 5-5 of the Uniform Act.
[29] Olivares-Caminal 2015.
[30] IMF Global Financial Stability Report: Moving from Liquidity to Growth Driven Markets 2014.
[31] European Commission 2011.
[32] World Bank 2016. Insolvency and Creditor/ Debtor Regimes Task Force Report
[33] Bergthaler and Monahan 2015.
[34] Garrido 2012.
[35] Garrido 2012.
[36] According to Article 1-3 of the revised Uniform Act Organizing Collective Proceedings for Wiping Off Debts, “small company” is defined as an individual private company with no more than 20 employees and a turnover (without taxes) of no more than 50 million Central African Francs (CFA) during the 12 months before commencement of proceedings.

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