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## Bringing more credit to the private sector

VALERIE MARECHAL AND RACHEL (RAHA) SHAHID-SALESS

Most entrepreneurs wanting a loan go to the bank. But in countries with inadequate collateral laws banks are less willing to lend—as in Peru before the 2006 reform of its secured transactions law. In 2001 the minister of economy and finance acknowledged the problem: “Although Peruvian banks grant 90% of the financing for businesses, [the funds] that they input in the financial system represent only 26% of the GDP. This percentage is very low compared with the 70% in Chile or the 150% in the United States and Canada.”

To address these inadequacies—and motivated by the Inter-American Development Bank’s insistence on reform as part of a loan package—the government implemented a new law in June 2006. The new law was a positive step forward. Some inefficiencies remain, which if left unresolved, might hamper the new system’s effectiveness.

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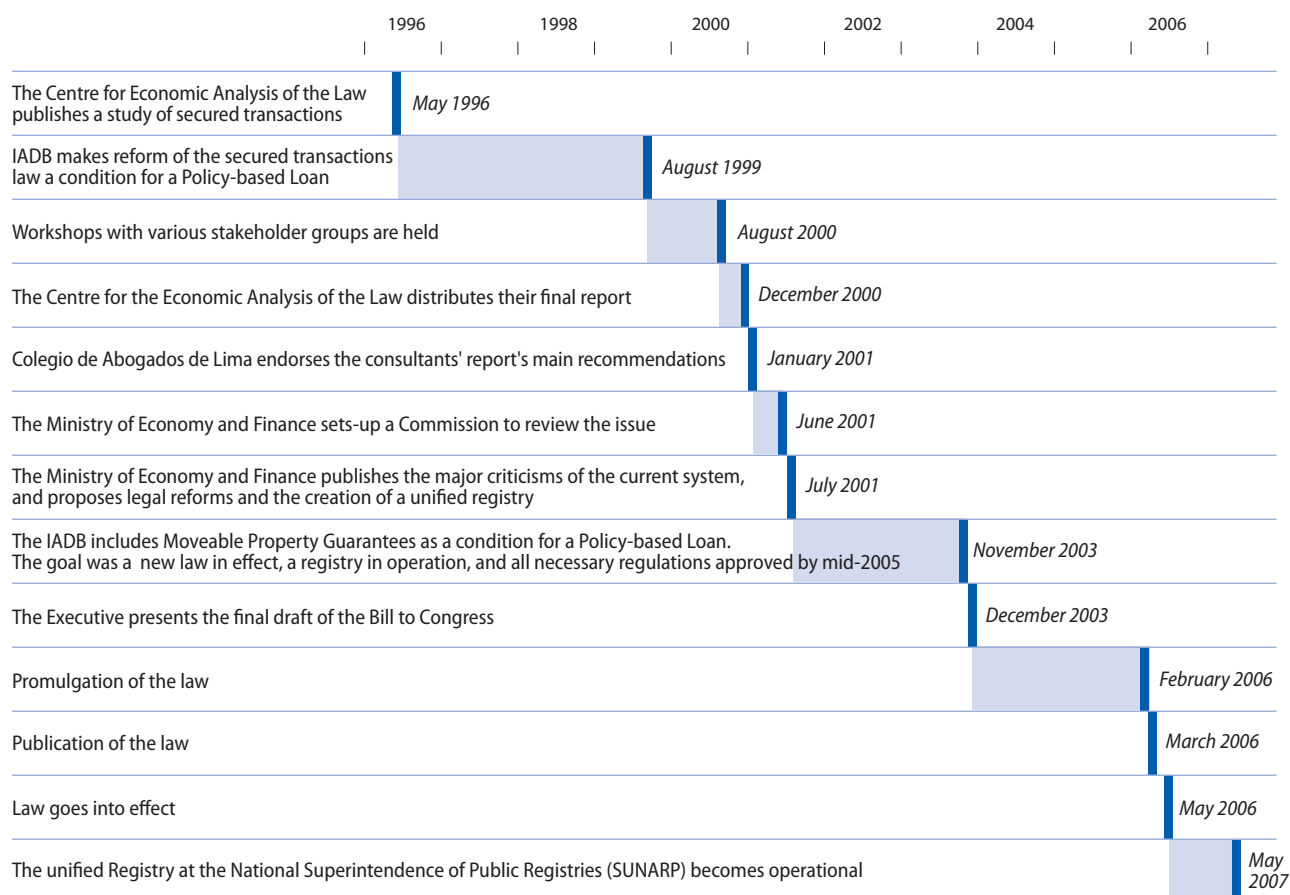
### 20 types of security interests, 17 registries

Before the reform it was difficult to create, register, and execute security interests in Peru. According to the Ministry of Finance and the Economy, moveable property accounted for about two-thirds of capital in manufacturing. But the law did not allow most types of moveable property to be used as collateral, including future assets and changing pools of assets. This left the lion’s share of small and medium-size businesses’ assets as “dead capital.” Further muddying the situation were Peru’s more than 20 types of security interests, varying from a commercial pledge to an agricultural or industrial pledge. According to a 2006 World Bank study: “Transaction costs rise when much time and effort must be devoted to determining whether the law permits taking a security interest in a particular item.”<sup>1</sup>

Other inefficiencies also plagued the process. To start, parties had to describe with specificity the movable assets used as collateral—say, by providing the serial numbers. This requirement circumscribed the use as collateral of key classes of business assets—such as inventory or accounts receivable.

For recording security interests, Peru had 17 registries for different kinds of assets, each with its own regulations and requirements. This system was a recipe for confusion and uncertainty. “Should a pledge on a commercial fishing boat be registered in the boat registry, the company registry, or the registry of inventory? If multiple pledges were filed in more than 1 place, which would have priority?” asks the World Bank study.<sup>2</sup> Consulting separate registries also increased transaction costs for the banks.

FIGURE 1

**Timeline of secured transactions reform in Peru***Source: Doing Business database.*

When a debtor defaulted, the procedure for a creditor to seize and sell the collateral was slow and onerous. Professor Mario Castillo Freyre from the College of Notaries of Lima highlights: “often the execution of the security interest would take longer than the economic life of most moveable goods, so depreciation would reduce the value to nothing by the time the secured creditor could collect.” According to the Ministry of Economics and Finance, the judicial execution of a security interest in Peru took between 18 and 24 months in 2001. By then, creditors lost a substantial portion of their investment. “If the creditor could recuperate the money within 3 months from the date of noncompliance, rather than 18 months, the applicable interest rate could come down up to 3 percentage points”, highlights the Ministry of Economics and Finance.

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## 5 years to reform

In a study published in 1996, the Center for the Economic Analysis of the Law showed how the shortcomings of the secured transactions laws limited access to credit in Peru. This motivated the Inter-American Development Bank (IADB) to link certain provisions of its loans to Peru's secured transactions reform. The main challenge, according to the IADB, was that the banking community and some in the Ministry of Economics and Finance were still not fully convinced of the need to have a reform.

The government held workshops in August 2000 on the draft report prepared by the consultants with the Center for the Economic Analysis of the Law. Business groups responded positively, identifying how moveable property guarantees could benefit them.

Following these workshops, the consultants from the Center for the Economic Analysis of the Law distributed their final report, which a local university published in December, 2001. A turning point came in January 2001, when the Lima Bar Association endorsed the main recommendations. The Ministry of Economics and Finance formed a commission to review the issue in June 2001, and the cabinet of advisors released a white paper in July. The white paper proposed changing the law and creating a unified collateral registry. The Ministry of Economics and Finance then set up a commission to draft the Bill on Guarantees Based on Moveable Property. External consultants and the National Forum on Competitiveness provided comments and modifications to the text, which the executive branch presented to Congress on 19 December 2003.

After more negotiations—including agreements with the notaries who wanted to maintain an active part in the new system, and with interest groups reluctant to subordinate wage claims to the claims of secured creditors—Congress approved the law on 10 February 2006. The President promulgated it 2 weeks later, and it was published on 1 March. The new law entered into force on 30 May 2006 after almost 5 years of discussion.

The reform included reorganizing the security registration system. Two options were on the table: to create an entirely new registry or to unify the multiplicity of registries electronically. According to projections, the first solution would cost \$5 million, and the second \$2.9 million. The reformers chose the second. The new unified database became operational on 30 May 2007, a year after the new law entered into force. The final cost of the reform is not yet known.

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### More flexible rules on collateral

The Bill on Guarantees Based on Moveable Property (Law 28677) redesigned Peru's rules on collateral. Almost any type of moveable asset, tangible or intangible, present or future, can now secure a loan. The more than 20 different pledges were aligned under a single system: guarantee based on moveable property. The new law abandoned the requirement to describe assets specifically. Pledges on movable property are now recorded in two registries: one for movable property that consolidates the 17 old registries and a new registry for contracts. Finally, the law allows parties to agree to sell the asset without court intervention if the debtor defaults.

Thanks to the changes, Peru's ranking in the *Doing Business* Legal Rights Index jumped from 164 to 93 of 178 economies. But the law did not remedy all the system's shortcomings.

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### Criticisms of the new system

Although the reform was a positive step forward, it suffered from weaknesses at the drafting stage. Some of these flaws were the result of political compromises being made. For example, recognizing the importance of notaries in Peru's legal system, the new law maintained their role. However, it took no steps to make their services more affordable and readily available across the country.

The Chamber of Commerce of Peru had been the new law's most vocal critic after its implementation, arguing that the law should have been suspended until the registry was fully operational. Its complaint: "the lack of technological interconnection at a national level between the various registries guarantees neither compliance with the law nor the judicial security of the transactions." Scholars and few members of Parliament have also asked whether allowing out-of-court enforcement and thus allowing debtors to renounce a trial is constitutional in a civil law system.

Other criticism came from experts who believed that the final text of the law did not include certain recommendations they considered essential for increasing the law's effectiveness. According to experts from the Center for the Economic Analysis of the Law, "the new law...will not permit the divisibility of the collateral to allow for the maximum possible use of capital for credit with more than 1 lender. It effectively raises the cost to the borrower of seeking other lenders. The new law does not void clauses that require payment of the entire loan if a second priority security interest is created, defeating most of the potential benefits of broadening access to credit."

In addition, the law remains unclear in some areas. For example, the law does not specify whether once a floating loan is paid back, the registration on that loan will terminate or not. This is critical as having to re-register a loan every time the loan is paid off will mean that the creditor may lose its priority in the re-registration process on the same collateral. Repeating the registration process on the same asset would add to transaction costs and be superfluous.

Finally, the law stated that, should the parties not agree on the terms of the contract, upon non-compliance, the creditor, through a notary, can send a notice of non-compliance to the debtor. If the debtor fails to perform, three days later, the creditor can proceed with an extra-judicial sale through a third-party. As many critics, including the Lima Chamber of Commerce have pointed out, the three day deadline for the payment is very short, creating the possibility for abuse.

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### **The unified registry—implementation problems**

The main problem with implementing the new law stems from the registration system. The law gave the National Superintendent of Public Registries 60 days to develop the regulatory, logistical, and technological infrastructure to merge all registries on movables and centralize them nationally. After 6 months, the necessary system was still not in place.

The unified registration system suffers from many of the former system's shortcomings. Security agreements cannot be registered directly and still require the involvement of notaries, whose fees are not competitive, nor are they readily available in all areas. In addition, much time can pass between when the security agreement is submitted to the registry and when it appears online. As a result, information about a collateral agreement does not immediately become available to the public. During that lag, a debtor could secure several loans from different creditors with the same asset.

Another issue is the higher registration costs of the new system. According to Professor Castillo Freyre, registering a leasing contract for 20 automobiles costs \$6,000. Before the reform, it was not necessary to register this type of contract. High costs may handicap the new system's ability to increase the amount of private credit in Peru.

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### Insufficient training and knowledge

A major obstacle in implementing the law has been that the key actors—lenders, borrowers, and lawyers—lack knowledge and training regarding the new system.

Post-reform training for users was limited to only a few ad hoc seminars. Insufficient knowledge can have serious consequences, especially for less educated entrepreneurs and businesses in rural areas. Professor Ronald Cardenas Krenz, director of the Legal Department at the Universidad Femenina del Sagrado Corazon, notes that while out-of-court enforcement facilitates the execution of security interests and encourages lending, debtors may not fully understand that they are relinquishing the right to have a court adjudicate a dispute over default.

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### The law's impact

In the aftermath of enacting the law, there has been a steady growth in registering new collateral agreements on moveable property. In June, 2006, immediately after the law came in force, the rate of registrations was low, with only 103 registrations for the month of June. This was the result of uncertainties associated with the workability of new system. After June 2006, the rate of registration gradually and steadily increased. It reached the level of over 5,000 registrations in November, 2006 alone.

However, comparing the number of registrations on movable property prior to June, 2006 and post June 2006 does not tell the entire story. This is because prior to the reform in June 2006, the number of registrations on “movable property” was not counted as one category. Even post-reform, the number of registrations in this category is not routinely measured. Moreover, delays in implementing the new registry often held up the effective use of the system.

Nevertheless, lenders have demonstrated optimism. Representatives of commercial banks have repeatedly echoed that the possibility for lenders to use extra-judicial remedies should reduce the risk of not recovering loans. With faster and more reliable recovery instruments, lenders will no longer transfer the risk to debtors by charging a higher interest rate.

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### The lessons

Other countries can learn from the positive aspects of Peru's reform. Peru moved ambitiously to unify its registration system, simplify the enforcement of collateral agreements, and expand the pool of assets usable as collateral.

Based on Peru's experience, countries may want to consider 4 elements when reforming their secured transactions laws:

Recognize the importance of the support and involvement of local stakeholders (in this case, the Lima Bar Association) as an important and necessary impetus for a successful reform.

Synchronize the start of the new registry's activity with the law coming into force. This will guarantee that the technical and administrative regulations to implement the new system are in place.

Set registration costs at reasonable rates, because excessive costs discourage financing.

Develop, before implementing the law, a strategy for dissemination and training, aimed not only at the financial and legal industry but also at non-institutional users of the system—say, small businesses and borrowers in rural areas.

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**Notes**

1. Heywood Fleisig, Mehnaz Safavian, Nuria de la Peña, Reforming Collateral Laws to Expand Access to Finance, The World Bank, Washington D.C., August 2006
2. Ibid