Capacity Building as a Key Determinant of Success in Secured Transactions Reform

Neil B. Cohen
Jeffrey D. Forchelli Professor of Law
Brooklyn Law School
Brooklyn, New York USA
Key Players in a Secured Transactions Regime

• Secured transactions reform has been the province of lawyers
• But:
  • It is clients who are the economic actors who engage in secured transactions
  • It is economists and other government officials that supply the regulatory framework
• Effective development of a secured transactions economy requires attention to those actors and their needs.
Basic Economics of Credit

• Credit transactions do not occur unless they are foreseen as profitable for both parties

  • For creditors, amounts received in payment (principal plus interest) must exceed cost of funds plus expected losses from defaulting debtors

  • For debtors, the anticipated return on the use of borrowed funds must exceed the cost of the funds (i.e., the interest rate)
Basic Economics of Credit

• The higher the expected losses from default, the higher the interest rate must be for a creditor to foresee a credit extension as profitable

• But as the interest rate increases, it is less likely that a transaction will be seen as profitable by the debtor

• Thus, both parties have an incentive to reduce expected losses from default so credit transactions can be seen as mutually profitable

• Secured transactions exist to reduce expected losses from default, enabling more credit transactions to go forward
Law Reform Alone Is Not Enough

• Over 20+ years, UNCITRAL has generated a template for a well-functioning secured transactions legal system.
• Legal regimes based on that template create a toolkit for the economic actors (particularly creditors), enabling additional credit transactions at lower cost
• But tools don’t use themselves
• Tools are useful to those who have, or invest in, building the capacity to use them
Law Reform Alone Is Not Enough

• Providing a State with modern set of secured transactions tools in form of new law does not automatically result in creditors using those tools to extend credit

• Rather, creditors often do not embrace transactions newly made possible on a profitable basis by law reform until the creditors have the practical capacity to use the new legal rules effectively

• Law reform without capacity building may not be effective
What Types of Practical Capacity Are Needed?

- Skills that are needed include:
  - Valuation of collateral
  - Use of concepts such as borrowing base to determine how much to loan, particularly in the context of revolving credit and a changing mass of collateral
  - Administration of secured loans
  - Non-judicial repossession and disposition (see presentation of Teresa Rodríguez de las Heras Ballell)
  - Collection of receivables
Valuation

- The secured credit bargain creates a legal right.
- But the amount of protection against loss that the bargain provides is determined by the value of the collateral.
- More particularly, by its value in the context in which the collateral is likely to be disposed of.
- Thus, determining how much risk of loss is reduced by collateral requires expertise in estimating the amount that would likely be received upon its disposition.
Borrowing Base

• When debt is revolving and the collateral consists of a fluctuating mass of property with too many items to efficiently evaluate each one separately, determining the maximum amount to be borrowed can be complex.

• Secured lenders in such transactions develop expertise in concepts such as defining a borrowing base and the development of formulas to determine how much can be safely loaned against the collateral (e.g., lender will extend credit against 70% of the face amount of “qualifying receivables,” etc.)
Administration of Secured Loans

• Trust, but verify

• Expertise needed to audit matters related to collateral, including:
  • Continued existence
  • Quantity
  • Condition
  • Fluctuations in value
Collection

• When the collateral is receivables (or other rights to the payment of money, including debt securities) additional capacity is required

• Collection from the debtor of a receivable requires different skills than repossessing and disposing of a piece of equipment
  • Equipment does not care who owns it, but debtors on receivables often do care about the identity of obligee
  • Can be difficult to find debtor of a receivable
  • Use of historical data or information about the debtors on receivables to place a value on receivables at time of transaction
Investment in Legal Capacity

- Modern secured transactions law is complex, and exercise of rights is governed by complex rules
  - Development of legal capacity is an investment that generates return over time
- Additional legal expertise needed in related areas of law, particularly insolvency