

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