Secured credit and micro-enterprises

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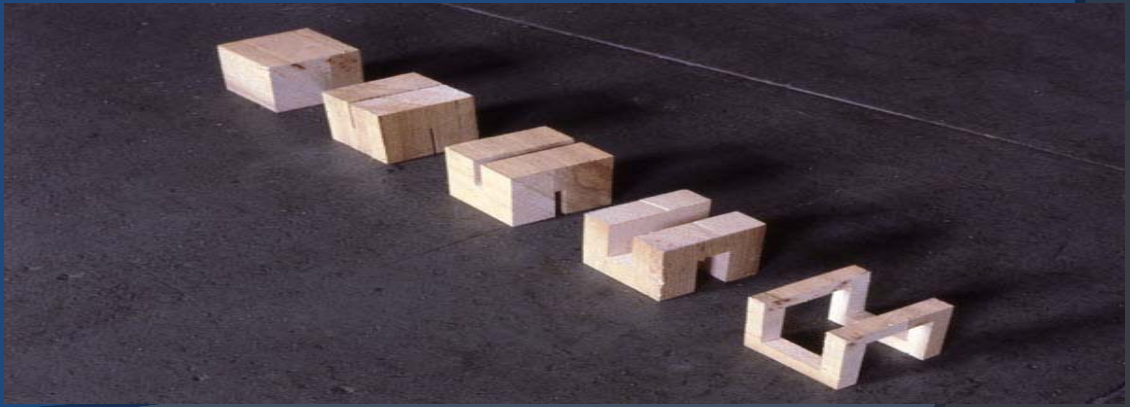
Summary

- Introduction: Secured credit and entrepreneurial activity
- Are micro-enterprises and micro-finance institutions different?
- Challenges in the use of security interests in financing micro-enterprises
- Adaptations of the framework to the needs of micro-enterprises
- Conclusion



Introduction: Secured credit and entrepreneurial activity

What is the function of secured credit?

Competing explanations:

-Risk reduction

-Reduction of monitoring costs

-Signaling

-Bonding

Introduction: Secured credit and entrepreneurial activity

Positive effects of secured credit on entrepreneurial activity: Necessary features of the regime

-Flexibility

-Non-possessory interests

-Affordable costs, simplicity

-Enforcement

(See Rec. 1 of the Legislative Guide)

Are micro-enterprises and microfinance institutions different?

Credit rationing and micro-enterprises

- Lack of liquidity
- Lack of capital
- Numerous problems

in access to finance

- **The role of microfinance institutions (MFIs)**

Are micro-enterprises and microfinance institutions different?

- **A look at some microfinance practices:**
  - *Selection of borrowers based on repayment capacity, business plans, other factors*
  - *Short term finance, liquidity*
  - *Small capital needs*
  - *In many countries, very little use of security interests*

Are micro-enterprises and microfinance institutions different?

Some examples of microfinance practice and the (lack of) use of security interests:

Fundusz Mikro (Poland)

The credit worthiness criteria used in decision-making are:

(1) Motivation to repay

(2) Entrepreneurship / Entrepreneurial skills

(3) Business viability

(4) Cash flow coverage

Source: J. Evers – A. Loeft

Fundusz Mikro (Poland)

No physical collateral is accepted by FM because they believe it would weaken borrowers' sense of personal responsibility for repayment. The "motivation" to repay is assessed in-depth, through the character of the client.

FM aims at establishing a long term relation with the client, which provides security in itself. The essential security is provided by the fact that only small loans are available in the first instance, and that new and larger loans can only be obtained if the previous loan is repaid fully and on schedule. Thus, the expectation of a new, larger loan is a form of security.

Peer pressure or "social collateral" applied through group members is essential. If one member of the group does not repay on schedule, follow-up loans will not be available to anyone in the group.

Source: J. Evers – A. Loeft

Policy of Grameen Bank (Bangladesh)

Grameen Bank **does not require any collateral against its micro-loans.** Since the bank does not wish to take any borrower to the court of law in case of non-repayment, it does not require the borrowers to sign any legal instrument. Although each borrower must belong to a five-member group, the group is not required to give any guarantee for a loan to its member. Repayment responsibility solely rests on the individual borrower, while the group and the centre oversee that everyone behaves in a responsible way and none gets into repayment problem. There is no form of joint liability, i.e. group members are not responsible to pay on behalf of a defaulting member.

Are micro-enterprises and microfinance institutions different?

- Less use of security interests, in most countries
- Relational lending, use of alternative instruments to

A) assess risk
B) reduce risk

- Consideration of the costs
- Scarcity of assets
- Use of alternative mechanisms:

-Credit relations as a repeat game
-Reputation and commitment of the group
-Use of security interests in their “bonding” function

- **Implications**

Challenges in the use of security interests in financing micro-enterprises

- *Costs*
- *Lack of suitable assets*
- *Necessary possession of some assets*
- *Inadequacy of the legal framework*
- *Risks of loss of the collateral, lack of value*
- *Enforcement*

Adaptations of the framework to the needs micro-enterprises

-Use of possessory security interests

-Direct possession

-Indirect possession

-Bonding effect, less risk of loss of collateral

Adaptations of the framework to the needs of micro-enterprises

-Security over exempt assets

-Use of reservation of title, acquisition finance and leasing for certain loans

-Use of general security interests



Adaptations of the framework to the needs of micro-enterprises

- **The problem of costs (low value of loans, low value of collateral)**
- **A system with no creation or registry costs?**

Adaptations of the framework to the needs of micro-enterprises

- Enforcement
- MFIs use alternative collection mechanisms (avoid costs)
- Out-of-court enforcement
- Legal obstacles and debtor protection

Conclusion

- Secured Transactions Law as a public good
  - "Functional approach"
  - Benefits all kinds of enterprises
  - Minor adaptations for microenterprises
  - But microenterprises have other challenges: transparency, financial consumer protection, collection practices, insolvency