Ivor Istuk and Ahmed Meziou

COLLATERAL
WHERE DOES REFORM STAND TODAY?

Laws affecting secured transactions and their implementation directly influence the availability and cost of credit and the efficiency of the market for secured credit. Whether it is a farmer who needs to borrow money to buy a tractor, an enterprise that needs credit from its supplier, or developers of a power plant who need to finance a major new project, the inability to obtain valuable and viable security over a debtor's assets is likely to discourage potential credit providers.

The primary objective of improving secured transaction laws is economic. A lender or creditor will accept a mortgage or a pledge in order to reduce the risk of losing the money that he is owed. If the law, or the way in which it is applied, does not give creditors confidence that they can recover real value from mortgaged or pledged assets, collateralising will have little economic benefit. On the other hand, a lender with legal rights to turn to his debtor's assets in case of non-payment will assess credit risk quite differently, which may influence his decision on whether to give credit or not. It may also change the terms under which the creditor is prepared to lend, either by increasing the amount of the loan, extending the period for which the loan is granted or lowering the interest rate.

The EBRD Secured Transactions Project was established in 1992 to encourage countries to update their collateral laws and also offer assistance at all stages of the reform process. In 1992 most countries in which the EBRD invested either did not have any rules on secured transactions or had outdated or inadequate rules, which did not give creditors the economic benefits that one would expect from security. In 2014, as part of its regular assessment of transition challenges, the EBRD Financial Law Unit conducted an extensive legal framework assessment to examine the practices and effectiveness of taking collateral in countries where the EBRD works (the Secured Transaction Assessment).

"The primary objective of improving secured transaction laws is economic."

1

2

"The EBRD Secured Transactions Project was established in 1992 to encourage countries to update their collateral laws and also offer assistance at all stages of the reform process."

AUTHORS

1 IVOR ISTUK
PRINCIPAL COUNSEL
EBRD
EMAIL: ISTUKI@EBRD.COM

2 AHMED MEZIOU
LEGAL SPECIALIST
EBRD
EMAIL: MEZIOUA@EBRD.COM

The assessment examines the options available for securing different types of assets. In addition to security interests, which grant ancillary property rights over the asset (pledges and mortgages), the assessment also includes quasi security such as sale and leaseback transactions (finance leasing), assignment of accounts receivable and financial collateral. The assessment also looks at the processes for creating, perfecting and enforcing a security interest. The approach was based on legal efficiency methodology developed by the EBRD, which outlines the key objectives of secured transaction reforms. According to these objectives, the law should not only fulfil its basic legal function, but should also maximise economic benefits for the parties.

In other words, the assessment aims to gauge the extent to which existing legal regimes allow creditors to take security on different assets, with the view of giving secured creditors legally enforceable rights to the collateral in priority over other creditors in case of default. It also examines whether the adopted solutions fit well with the economic, social and legal context of the examined jurisdiction.

The overall results show that considerable progress has been made in collateral reform by the region as a whole in the course of the last 25 years or so. All transition countries have laws in place, which generally provide for the creation of security interests (or quasi security interests) over movable and immovable assets, and such interests tend to be publicised through a registration system. This is an interesting finding given that the region's political landscape has been very diverse, to say the least, and that reforms have proceeded at different times, under different agendas.

However, in spite of this great progress, it is also evident that the countries' legal frameworks for collateral are not equally "legally efficient", and that even the best performing systems would benefit from further improvements in certain areas. Enforcement procedures and more sophisticated instruments, in particular, would enable modern types of financing, such as security over bank accounts, syndication and grain warehouse receipts.

With regard to developing and implementing collateral law, it seems that the countries in which the EBRD invests can be divided into three main groups. The first group comprises countries that have achieved a fairly sophisticated level of development. They have modern secured transaction systems (both mortgage and pledge) that are being used in practice. This group includes countries from central Europe and the Baltic states, eastern Europe and the Caucasus, south-eastern Europe and Russia. For the purposes of this article we will use the acronym CESECBR for these countries.

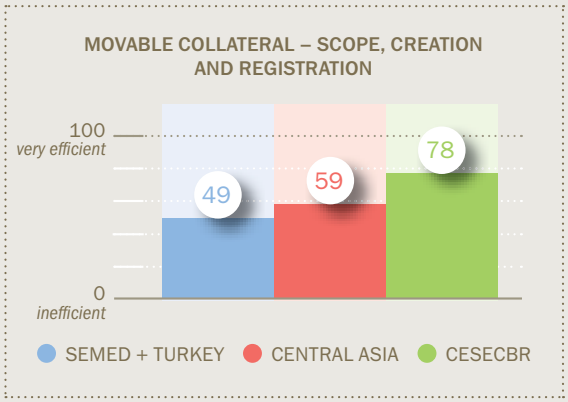
The second group consists of countries that have implemented reforms but their systems, especially for security over movable assets, have not lived up to expectations due to either a lack of proper implementation capacity, poorly drafted or incomplete legal provisions, or a lack of economic activities, which has limited the development of established practices. This group includes countries from Central Asia.

The third group represents countries that joined the Bank later in the process of transition. In these countries, movable property pledges are based on variations of the French *fonds de commerce* (pledge over business assets). This group includes Turkey and countries from the southern and eastern Mediterranean (SEMED) region.

Grouping countries is always a difficult task but analyses of the status of development of legal frameworks, and the efficiency of taking collateral in general, showed more or less consistent results within the groups. There were deviations within each group (countries that are still catching up with the average or are ahead of the rest of the group) but in general it is safe to say that within groups one can find similar results across. The differences between the groups are easily identifiable when features such as scope, creation, registration and enforcement of security rights are cross-compared (see Charts 1-2).

EFFICIENCY OF COLLATERAL-TAKING AND ENFORCEMENT IN THREE REGIONS WHERE THE EBRD INVESTS

CHART 1



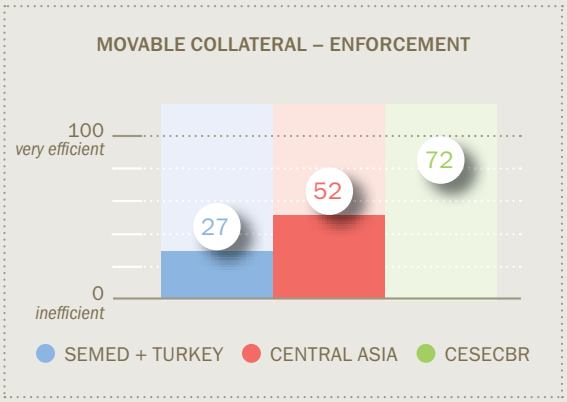
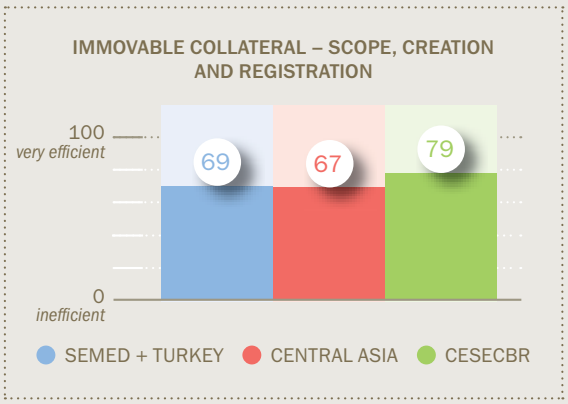
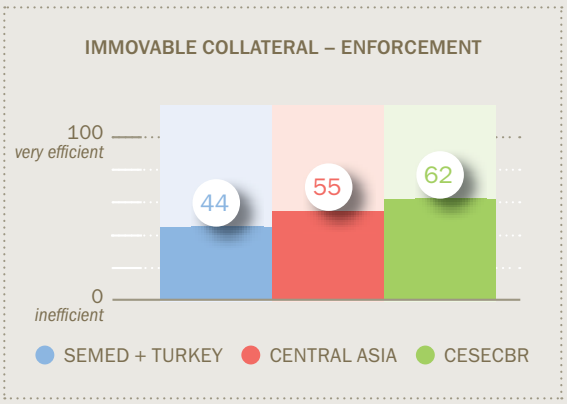


CHART 2





Note: SEMED includes Egypt, Jordan, Morocco and Tunisia. CESECBR includes central Europe and the Baltic states, eastern Europe and the Caucasus, south-eastern Europe and Russia.

Source: Secured Transaction Assessment 2014

Another interesting fact brought out by the assessment is that enforcement is the weakest area in all systems across the board. However, efficiency is correlated with the overall success of the system. Efficient legal systems in central Europe, for example, score better on enforcement overall than systems in the SEMED countries where, as mentioned, full-blown reforms have not taken place. In addition to intrinsic weaknesses in the systems, enforcement procedures have also been subject to a number of regulations that have been motivated by social concerns triggered by the financial crisis in 2008. For example, pre-pack procedures for insolvent corporates preventing or postponing enforcement of collateral in Croatia, or protection for residential property owners in Hungary by mandating grace periods before starting enforcement procedures over such properties. Work on achieving efficient, and at the same time socially sensitive enforcement regimes, will probably be the focus of any future reforms in this field.

The following section examines each group of countries in turn and analyses the findings of the assessment in further detail.

EUROPE – A SUCCESS STORY IN NEED OF FINE-TUNING

When the EBRD started working in the region in 1992 none of its countries of operations had any practical laws that allowed non-possessory security over movable assets, except for a few countries with laws that pre-dated the Soviet era, but these could not be described as efficient.[1] In addition, taking collateral over immovable property was burdened either by inefficient rules or inadequate (or, in some places, inexistent) land registers (cadastres).

These countries, supported by international financial institutions, launched ambitious and exciting reforms, involving local and international businesses and legal communities. This resulted in reformed laws and developed and/or developing institutions. Effective tools, such as centralised collateral registries, improved the accuracy of land registries. In addition, clearer, more predictable contractual rules were put in place to increase the legal certainty of financial activities.

Today most of the countries belonging to the CESECBR group have centralised land and pledge registries operating at a satisfactory level, and in some cases well above, from a user perspective. This means that financial institutions and investors can depend on a reliable source of public data when making business decisions. For example, 16 out of 23 countries in this group provide direct or indirect online access to land registries and 15 countries offer the same services for pledge registries (with 18 having introduced modern all-encompassing pledge registries).

TABLE 1 REGISTRATION SYSTEMS IN EUROPEAN COUNTRIES IN WHICH THE EBRD INVESTS

	Land Registry		Pledge Registry	
Countries	**Existence of a land registry**	**Online access to land registry**	**Existence of a pledge registry**	**Online access to pledge registry**
Albania	✓		✓	
Armenia	✓			
Azerbaijan	✓			
Belarus	✓	✓		
Bosnia and Herzegovina	✓		✓	✓
Bulgaria	✓	✓	✓	
Croatia	✓	✓	✓	✓
Estonia	✓	✓		
FYR Macedonia	✓	✓	✓	✓
Georgia	✓	✓	✓	✓
Hungary	✓	✓	✓	✓
Kosovo	✓		✓	✓
Latvia	✓	✓	✓*	✓
Lithuania	✓	✓	✓	✓
Moldova	✓	✓	✓	
Montenegro	✓	✓	✓	✓
Poland	✓	✓	✓	✓
Romania	✓		✓	✓
Russia	✓	✓	✓	✓
Serbia	✓	✓	✓	✓
Slovak Republic	✓	✓	✓	✓
Slovenia	✓	✓	✓	✓
Ukraine	✓		✓	✓

* Pursuant to Latvian law, registration requirements for collateral over movable property only apply to commercial pledges (extended by legal persons involved in business activities), which are registered in the Commercial Pledge Register.

However, the efficiency of these registries, or their reliability when checked remotely (online), differs from country to country. They range from a very successful system in Romania, to a less reliable one in Montenegro, to a system in FYR Macedonia that is still in the process of redevelopment.

Exceptions are Armenia, Azerbaijan, Belarus, Estonia and Latvia, which still have not introduced a modern all-encompassing system of taking non-possessory collateral over movable property and property rights. The development of pledge laws in these countries ranges from a very well-developed and flexible system, such as the Commercial Pledge Law in Latvia (which covers all movable assets and is almost an all-encompassing, modern legal pledge system, except that the pledge can be extended only by a legal person engaged in business), to limited non-possessory pledges over businesses (mortgages) and non-possessory pledges over registered movable property only (for example, intellectual property or ships) in Belarus and Estonia. This is not to say that these countries are standing still. Indeed, reforms are ongoing in Armenia, Azerbaijan and Belarus.

Another significant change that has happened in the region since the start of its transition relates to restitution claims for real estate and land registration. It seems that restitution claims in most of the countries have been resolved or are no longer seen as a major risk to the reliability of land registration systems (which is key for the creation of mortgages). Only in Romania and Serbia has it been reported that the process of registering land and buildings in cadastres is still seen as a potential impediment to lending.

In addition, the legal framework in countries belonging to this group does not impose any restrictions on who can extend or take collateral (except agricultural land, where the rules differ, and publicly owned residential properties). The debt can in most cases be described with enough flexibility to encompass future and fluctuating obligations (for example, revolving loans). Furthermore, we can generally conclude that the majority of the countries have achieved a very good level of satisfaction with regard to the basic legal functions of collateral laws.

Where the countries differ most and where major efforts should be invested in the future, are in areas related to specific, sophisticated products or transactions, including: the ability to use collateral managers (agents, trustees) in syndicated lending; the pledging of bank accounts; security over accounts receivable (for example, the requirement that all accounts receivable should be specifically identified when the security is created, is impractical); the extension of mortgage rights over land used to erect buildings in construction projects, and so on.

Most of the countries do not have rules that support security manager structures. This is all the more surprising given that syndicated lending is well developed in central Europe and the Baltic states, and that the alternative of parallel debt structures presents considerable legal uncertainties. Positive developments can be seen in recent legislative changes in Hungary, Romania and Russia where new civil codes introduce the concept of security managers. Meanwhile, in Serbia, laws in relation to security over movable assets have been in place for some time, and the country is currently trying to introduce similar regulations to the Mortgage Law.

As financial markets further develop and evolve, taking into account the lessons learned from the financial crisis, it is logical to expect some fine-tuning of the reforms. The challenge for market players will likely be to bring the legislators' attention to what may appear to be small gaps and seemingly insignificant problems (as the "modern" systems have already been introduced) and to secure legislative and academic approval of these changes.

SEMED AND TURKEY – TRANSFORMING THE LEGAL SYSTEM FOR SECURED TRANSACTIONS

In SEMED countries as well as in Turkey, legal frameworks for collateral have existed since the very beginning of the 20th century and are largely influenced by a combination of the French Civil Code, the Ottoman Civil Code and Islamic law.

Land and buildings are often not registered, or the property rights over them are unclear or subject to a complex and overlapping set of rules, which ultimately impedes the efficiency of mortgage lending. The strict requirement of debt specification is also an impediment, making it near impossible to secure future debts and fluctuating debt such as revolving loans.

Neither the SEMED countries nor Turkey have a modern all-encompassing law for taking non-possessory security over movable property. These countries have outdated and fragmented provisions governed by different laws and regulations, which have in most cases (except Jordan) not been reformed for many years. This makes taking security a complex and costly process as each legislation and regulation provides its own set of rules for creating, registering and enforcing security. Furthermore, the types of assets that can be used as collateral are quite limited (see Chart 3).

One of the most commonly used security instruments is security over a *fonds de commerce*. This is a legal concept originally developed under French law, which primarily targets the intangible assets that make up a business – the enterprise's commercial name, goodwill, leasing contracts, but also in some cases equipment and inventory. These elements can collectively be pledged to creditors on a non-possessory basis subject to registration.

CHART 3 TYPES OF ASSETS THAT CAN SERVE AS COLLATERAL IN SEMED AND TURKEY

	Egypt	Jordan	Morocco	Tunisia	Turkey
Fonds de Commerce	✓ [a]	✓ [b]	✓ [c]	✓ [d]	✓ [e]
Equipment and machinery			✓	✓	
Pledge of agricultural commodities			✓	✓	
Pledge of mining products			✓	✓	

[a] Can include only trade name, leasing contract of the premises, goodwill, trademarks, licences and permits, furniture, machines and equipment related to the activities of the enterprise.

[b] In accordance with the law concerning mortgages of movable property (Jordanian Law No. 1/2012), this type of pledge includes all the movable assets of a company/trader. There is no "cherry picking" of assets that are pledged, as this pledge is only taken when it covers all the business assets owned by the charger. This charge can include movable assets owned by the company/trader such as vehicles, airplanes, vessels, intellectual property, securities, inventory or machinery; and are subject to registration. However, according to local practitioners, the mentioned law has not yet come into force.

[c] Can include only trademarks, leasing contract of the premises, goodwill, commercial furniture, machinery and equipment related to the activities of the enterprise, intellectual property and inventory.

[d] Can include only trademarks, intellectual property rights, leasing contract of the premises, goodwill, commercial furniture, machinery and equipment related to the activities of the enterprise. Cannot include inventory.

[e] Can include machinery, equipment, tools and motor vehicles that are used for the operation of the enterprise at the date the charge is created.

Evidence of the need for law reform is usually found when market practices develop to "circumvent" these very legal provisions. These practices can achieve the intended result, but such results tend to be legally risky and come at a high cost. For example, it seems that banks in Egypt engaged in financing small and medium-sized enterprises find that the *fonds de commerce* mortgage is too cumbersome as many of the assets that would be included into the mortgage are not sought after by the bank, or the borrower may not be prepared to grant the bank a security over them as the value would be disproportionate to the secured debt. In addition, as the mortgage requires the agreement to be notarised and registered at a competent commercial registry, the transaction costs are disproportionately high. Therefore, banks have in some instances reverted to taking a possessory pledge over the assets they are willing to accept as collateral, and including in the pledge agreement the provision that the transfer of possession will be made to the manager of the debtor company acting as a third party for the interest of the bank (custodian).

A similar example is found in Jordan for equipment and machinery pledges, where possession is entrusted to an independent third party known as the *Adel*, which then "on-lends" the relevant assets to the pledger for its use. This may be a well-accepted practice; however, it would make much more sense to legally recognise the concept of non-possessory security over assets, which would be defined as the parties deem fit, and to review the conditions of validity of the security agreement in order to keep transaction costs low.

Enforcement is another issue that would benefit from reform. Out-of-court enforcement is non-existent as none of the countries generally allow enforcement outside of judicial proceedings (with some exceptions, such as the pledge of bank accounts in Tunisia, or the share pledge given to Egyptian banks). When it comes to enforcement over collateral, creditors do not play any role in the process, which takes the form of a public auction, resulting in delays and devaluation of the assets below fair market prices. This is, to some extent, avoided in Turkey by fiduciary security assignments where the creditor owns the assets for the duration of the loan. The transaction has been recognised by various Supreme Court judgments, although it does not have legislative underpinning.

Due to the fact that collateral systems already exist in these countries, if and when embarking on legal reform, decision-makers may be faced with a choice between undertaking a general overhaul of the system by repealing all existing legal provisions and adopting a new single law, or amending and fine-tuning the existing legal framework. While the latter approach may seem more appealing to law-makers (since it appears to be a simpler exercise and does not require a drastic departure from existing tradition and practices) sometimes introducing amendments does not bring the same clarity that an overall reform might offer; that is, the final framework could end up being very complex and may include contradictions and loopholes.

The motive when tackling reforms should be the end result and not the complexity of the process. In this context, it is worth mentioning that Morocco is currently pursuing a general overhaul reform of its secured transaction system, supported by the EBRD, the World Bank Group and the Arab Monetary Fund.

CENTRAL ASIA – THE LONG JOURNEY OF REFORM

In contrast to the previous group, where a system of secured transactions has been in place for decades (albeit in need of reform), Central Asian countries (Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan) had to start building their systems from scratch at the beginning of their transition.

The countries underwent major reforms by adopting new civil codes, often influenced by the German tradition. These codes provided a general framework for taking security over immovable and, in some instances, movable assets. However, the codes contained some rather obsolete concepts, such as dating the opposability of a security from the moment of signing the agreement rather than on registration in a public register, as is the case in Mongolia for security over movable assets. These laws have since been amended in most cases or supplemented with specific laws on mortgages and pledges, and legal underpinning has been much improved. However, what still seems to be a major impediment is the implementation of infrastructure and/or active use of the developed systems in some jurisdictions.

For example, while Kazakhstan and the Kyrgyz Republic have introduced modern pledge registries, registration in the Kyrgyz Republic is mandatory only if debt exceeds a certain minimum threshold, and in Kazakhstan only a limited type of assets can be registered (such as rolling stock, tractors, promissory notes and securities). Mongolia and Turkmenistan do not have these registries in place and Mongolia even lacks a specific pledge law that would effectively resolve uncertainties arising from the Civil Code and provide legal underpinnings for registration. Uzbekistan has only recently introduced a registry of pledges (1 July 2014) hence no relevant practice exists yet. Tajikistan lacks a land registry, therefore information on eventual encumbrances over real estate has to be sought from the Minister of Justice, which runs a registration

system based on delivered agreements. All of this, coupled with the lack of market-based financing in some of the countries, impedes the development of these systems.

These countries are no exception to the overall finding that enforcement is lacking across the region, and almost all practitioners interviewed describe the enforcement process as cumbersome, lengthy and costly.

In addition to strengthening the building blocks of a sound legal framework for secured transactions, countries in Central Asia need to develop specific financial instruments or sectors, such as grain warehouse receipts or factoring and leasing, to improve access to finance in the region.

CONCLUSION

The 2014 Secured Transaction Assessment demonstrates that the countries where the EBRD works have achieved remarkable results in building secured transaction infrastructure over the past 25 years. Despite the fact that transition is a very slow process, sometimes even reversing, the assessment shows that the policy work of local and international stakeholders does make a tangible difference. However, it also shows that progress has not been uniform across the board and that there remains a need for tailor-made efforts in many jurisdictions.

In that sense the assessment results are encouraging, by showing what has been achieved, and at the same time can be used as a tool for working through reform agendas in the future.

"The assessment was based on legal efficiency methodology developed by the EBRD, which outlines the key objectives of secured transaction reforms."

"The assessment shows that progress has not been uniform across the board and that there remains a need for tailor-made efforts in many jurisdictions."

NOTE

1 EBRD Legal Transition Programme (2000), "Ten years of secured transaction reform", *Law in transition*, p. 1.