

Secured Transactions Reform: Early Results from Romania

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Introduction

When lenders can take collateral for loans, access to credit improves. In industrial countries, a borrower with collateral, relative to a borrower without, can get nine times more credit relative to cash flow, can have eleven times longer to repay, and will pay an interest rate about half as high¹

The legal framework that governs the use of collateral is the law of secured transactions. This note reports some preliminary results on the rapid progress of the World Bank's project in Romania, which supported the reform of this law and the creation of a modern filing archive, where lenders record the priority of their claims against the collateral.

Analyzing Archive Data

Number of Filings

After opening in late 2000, the Romania archive received 65,000 filings in 2001, rising to 171,000 and 190,000 per year in 2002 and 2003 respectively². As of mid-September 2004, 192,218 had already been filed. Under Romania's law, secured parties can file for different purposes. The most important among these are creating a new security interest, canceling an existing security interest (for example, on repayment

of the secured obligation), declaring an intention to file, and assigning accounts receivables. Total entries in the archive, therefore, may exceed currently active security interests. It is likely that the discrepancy is not so great as the typical maturity of a secured loan is about four years. Gross filings rose from 65,000 in 2001 to 236,000 and 426,000 in 2002 and 2003 respectively. As of September 14, 2004 cumulative gross filings amounted to 618,218.

Impact on Volume of Credit

As the notice of the security interest does not require filing the amount of the obligation secured, the amount of credit cannot be determined directly from the number of filings

The average private loan granted by the banking system at the end of 2003 was about \$73,301.59³. Had that represented the average security interest filed in the archive, the resulting increase in credit would be about \$32 billion. This is well beyond the total increase in private credit from financial institutions, which amounted to \$4.8 billion between 2000 and 2003⁴. We would expect total credit to increase faster than bank lending because of the effect of the law and the archive on increasing non-bank lending. However, without firm-level investigation it is

premature to conclude that it would have increased this rapidly.

However, other indicators are broadly consistent with a large and rapid increase in the volume of credit. The number of borrowers reported in the Central Banks debtor registry rose from 18,672 in 2000, to 24,240, 37,562, and 73,357 respectively in 2000-2003. The total volume of private bank credit rose \$4.8 billion between 2000 and 2003, rising as a share of GDP from 11.3% in 2000 to 11.4%, 13.6%, and 15.8% in 2001-2003 respectively.

Access to Credit

More borrowers

Access to credit in Romania broadened. At the end of 2003, there were 426,000 security interests filed in the archive, compared to 73,357 debtors listed in the credit reporting system of the Romanian central bank.⁵ Two channels exist by which the legal reform may have broadened access to credit. First, the expanded use of collateral may have permitted banks to expand their lending. As noted, bank borrowers increased from 18,672 in 2000, to 73,357 in 2003. Second, non-bank lenders used the archive to file security interests to secure the loans and credit they advance.

Smaller loans

Moreover, even if the 426,000 security interests were responsible for the entire increase in private credit of \$4.6 billion, that would imply an average loan size of about \$10,800. This is considerably lower than the average loan size of \$73,301.59 reported by the banking system.⁶ The unwillingness of banks to make small loans is a major barrier to access to credit. That the

new law facilitates such loans expands access to credit.

Broader Geographic Distribution

The law seems also to have a broad impact on access to credit outside urban centers. From the outset, design of the archive provided for operation by NGOs -- especially the chamber of commerce and the chamber of notaries. These organizations have branches that cover every county in the country. The filings by county show that of 43 counties, only one lacked filings in either 2001 or 2002. While the largest single amount of filings is in Bucharest (more than 30,000 in 2002), most counties show 2,500 - 5,000 filings. All counties but one show more filings in 2002 than in 2001. This wide geographic dispersion of filings bodes well for credit delivery in rural and other previously underserved areas. The dispersion of the filings arises for three reasons. First, the law specifies that any person or entity, including non-banks, can hold a security interest. This broadens the credit supply beyond traditional credit suppliers -- licensed banks. Such non-bank lenders are particularly important outside urban areas, where often no banks operate. Second, the law also specifies that any property or any transaction can serve as the object of a security agreement. This particularly encourages the use of property outside of major urban areas.

Finally, the filing archive itself is highly decentralized, permitting points of input at the location of any branch of an NGO archive "operator". In particular, to lower costs and promote sustainability, the law carefully defined what needed to be filed in the archive. This care in legal drafting permitted making a valid entry in the archive without paper. Designing a paperless archive allowed the filing archive to operate with full Internet-based input and access -- the first such filing archive in the world. Full Internet access, in

turn, permitted enormous economies in setting up and running the archive. Only one program needed to be written for and maintained on the main server. This strategy also avoided desktop installation of software packages. Avoiding desktop installation, in turn, side-stepped extensive design issues in adapting a program to different hardware configurations and operating system, and the expense of standardizing and maintaining such equipment. An Internet-based system permitted geographically-dispersed operators to access the archive with standard web browsers and passwords using their existing equipment. Since they already knew how to use their computers and their browsers, training costs were minimal. Indeed, the project supported no formal training.

Structure of the Financial Market

Entry of foreign banks

Archive records show filings by 106 banks. However, the National Bank reports that only 38 banks are fully licensed to do business in Romania. That this larger number of banks is filing security interests is consistent with the law's strategy in permitting any person or entity to create a security interest. The banking law's provision that only licensed institutions could extend loans was repealed. This legal drafting broadened participation in the financial sector beyond the existing established banks as well as permitting non-bank competition.

Most international banks present in Romania have filings in the archive. This rising participation is consistent with the sharp increase in foreign currency lending in Romania, up from 5.6% of GDP in 2000 to 8.5% of GDP in September 2003.

Non-bank lending

Finally, about 28,000 of the filed security interests represent loans by non-banks and individuals, indicating that the law has succeeded in encouraging non-bank financial intermediation.

Risk and Interest Rates

Consistent with the wider use of collateral in reducing risk, real interest rates drifted downward during the period. However, nominal and real interest respond to a variety of macroeconomic and inter-national factors, so more firm level data would be required to isolate the effect of the reform. Real interest rates were 12.6% in 2000, a "noisy" figure that is the difference between a high nominal rate and a high inflation rate. Real rates were 15.3%, 17.0%, and 11.4% in 2001-2003.

Operational Design

A successful reform of the law of secured transactions requires tight integration between the legal drafting, the technical characteristics of the filing archive, and the economic analysis of each step in the drafting. An economically effective legal strategy requires addressing four key problems:

Creation: ensuring that the legal framework permits anyone to take a security interest in any property for any transaction

Priority: ensuring that the order of claims against collateral is unambiguous and not contradicted by other laws

Publicity: ensuring that lenders can easily discover the claimants against collateral

Enforcement: ensuring that the lender, on default by the borrower, can quickly seize and sell the good given as collateral.

The details of the Romanian law are set out elsewhere, along with commentaries on the economic strategy that governed different elements of the drafting⁷

The tight integration of economic and legal work was important in ensuring that as the law's form changed to accommodate constraints in Romania, its economic impact remained the same. The intellectual challenges in adapting a law to different national circumstances are formidable, especially when integrating a U.S.-type UCC-9 system into a traditional civil code system like that of Romania. The depth of difficulty is reflected in the decision by a refereed law journal to publish the Romanian law with annotations.⁸ The decision to use lawyers with broad drafting experience in industrial countries and to work closely them in an economic analysis of their drafting choices was, in retrospect, well warranted.

The overall cost of the project was under \$1 million, which included all missions, legal drafting, supporting documents, and the programming and equipping of the filing

archive. No doubt, having it as a condition of a \$300 million adjustment operation helped focus attention on its importance. While a full evaluation would require a field visit, preliminary results from the filing archive indicate that the outcome of the reform appears to be billions of dollars in additional credit for Romania. Credit, moreover, delivered through sustainable private channels. The benefits from a well-designed reform of the law of secured transactions seem indisputable.

Rodrigo Chaves, Lead Country Economist for Turkey, managed the task for the Bank (Bank Projects: Private Sector Development Adjustment and Rural Finance Loans to Romania); Nuria de la Peña, Director of Legal Operations for CEAL, directed CEAL's legal work; Heywood Fleisig, CEAL Research Associate, led the economic and programming teams.

¹ See "Power of Collateral", www.ceal.org and www.worldbank.org.

² Data concerning the operation of the archive were kindly supplied by Sorin Teodoru of the World Bank's resident mission in Bucharest and by P. Stanescu of the Ministry of Justice of Romania. All data concerning Romanian credit come from the BANCA NATIONALA a ROMANIEI (BNR) and are available in the Statistical Section appearing at the BNR website at http://www.bnro.ro/def_en.htm.

³ BNR, Statistical Section, derived from "loans to private entities", table 22a; and "total loans", table 21.

⁴ BNR, Statistical Section, derived from "loans to private entities", table 22a

⁵ BNR, Statistical Section, table 21.

⁶ See note 3.

⁷ Nuria de la Peña and Heywood Fleisig, "Romania: Law on Security Interests in Personal Property and Commentaries", 29 *Review of Central and East European Law* 2004 No.2, 133-217.

⁸ See note 7.