STATE OF THE EVIDENCE: FINANCE AND MOVABLE COLLATERAL

INTRODUCTION

Timely access to appropriate financial products is critical for financing the agricultural technologies necessary to achieve Feed the Future goals. Access to appropriate financial products enables farmers to obtain the improved inputs and finance productive capital investments needed to boost productivity for small and medium sized farms. Yet the agricultural sector too often faces higher transaction costs and special production cycles distinct from other economic segments, posing special challenges to meet the needs of the sector.

The Enabling Agricultural Trade (EAT) project has undertaken several analyses of countries' enabling environment for agricultural finance, i.e. the system of government policies, laws, regulations, and institutions that govern the flow of finance for the agricultural sector. These studies found that systemic constraints in the laws and performance of regulatory bodies hinder access to credit and financial products for the agricultural sector. Whereas finance secured by movable collateral should be more accessible to the agricultural sector, regulatory, institutional, and cultural constraints have muted the positive effects.

This paper incorporates findings and lessons learned from EAT's work on the enabling environment for accessing finance with movable collateral. This paper supplements EAT project findings with recent evidence from research institutions, international organizations, and think tanks to understand what is known, and to identify knowledge gaps to support greater impact by the Feed the Future initiative. The following sections explore the documented costs of various legal, regulatory, and institutional challenges to agricultural finance and movable collateral, and provide information regarding the effectiveness of reforms.

EVALUATING THE EVIDENCE

Access to affordable finance remains a critical constraint affecting the ability of agricultural sectors to invest in improved efficiencies in agricultural production, trading, and marketing. Evidence suggests that a significant gap may exist particularly in regions where physical access to financial services is not readily available. In sub-Saharan Africa in 2008 the agricultural sector represents nearly one third of the region's GDP on average, yet in 2008 only represented 5.8 percent of total credit offered by formal financial institutions.[1] Unmet demand for just the smallholder segment of the global agricultural finance market is estimated at approximately $417 billion out of a total estimated market demand of $450 billion.[2] A significant gap exists between demand and supply of agricultural finance, typically because the anticipated returns do not support use of loan funds, particularly to small-scale producers.

For banks to be sustainable and profitable, revenues must exceed costs of capital and all associated risks of non-payment.[3] Innovative financial products, new mechanisms for financial delivery such as value chain finance, and targeted subsidy through guarantee schemes can be novel and discrete interventions that

[1] USAID, FS Share Project, *Lending to the Agriculture Sector: A Toolkit"* (December 2012). This is based upon a compilation of studies by the IMF in 2010 and the FAO in 2005, and is based upon banking sector lending in Botswana, Ghana, Kenya, Malawi, Mozambique, Nigeria, Sierra Leone, Uganda, Tanzania, and the Democratic Republic of the Congo.

[2] Dalberg Global Development Advisors, *Catalyzing Smallholder Agricultural Finance* (2012).

[3] Channell, Wade, "Bringing More Dead Capital to Life," USAID RAFI Notes Series, Issue 8 (2006).

Finance is not a Panacea

Debt financing can expand sound operations or rapidly reduce wealth with an unsound business model. In Mali in 2010, the Jameel Poverty Action Lab (JPAL) conducted a study to determine the existence of capital constraints affecting the agricultural sector across 198 villages in the Sikasso region.

JPAL found that capital constraints existed in villages that lacked financial services, yet in villages where financial services were available, grants provided to those who did not secure a loan yielded no returns. A sustainable strategy must be rooted in comprehensive, market-based interventions that reduce the costs and risks of lending, not upon a simplified approach of pushing finance out to a sector.

can marginally incentivize sector finance. However, without an efficient and effective secured transactions legal framework in place, agricultural finance will remain out of reach for higher-risk borrowers. Subsidized agricultural credit without a long-term strategy for reducing risk of non-payment to lenders might generate short-term gains but does not address the factors that drive up the cost of capital.

Small-scale producers in particular pose a challenge for many financial institutions. Small producers often face thin or nonexistent credit history, insufficient proof of profitability, weather risk, market fluctuation, and long production cycles which create unique risks for lenders. To mitigate these risks, financial institutions often require collateral which both serves as an incentive for repayment by the borrower, as well as a source of value to offset losses in the event of a default.[4]

Real property remains the favored collateral among financial institutions, yet this practice can pose a challenge for small-scale producers who have no formal title to their land, or who are unwilling to pledge their only productive asset. This situation particularly affects women, who in many countries have less access to clear title in their name. Women and smallholder farmers are typically more likely to own movable property in their name than real property, making movable property a priority reform. In Ghana, women were the primary beneficiaries of new loans secured by movable collateral after the collateral registry launched in 2008. Ghana launched Africa's first collateral registry in 2008, and over its first four years, the majority of loans were issued to women. [5] In the first six months of 2012 alone, the new registry in Ghana saw movable property pledged as security for more than 22,000 loans.[6]

Creating a legal and regulatory framework enabling movable collateral to secure finance

Across many developing countries, legal restrictions limit the types of movable property that may serve as collateral. Limitations on collateral stifle access to finance. Approximately 90 percent of the types of property that would be enforceable as movable collateral in the US would be unenforceable in Nigeria.[7] In Kenya, lending institutions may accept movable property as collateral under the Chattels Transfer Act, however the terms of the act restrict this category to truly transferable property, allowing for no fixture to the ground (e.g., limiting the use of irrigation equipment as collateral).

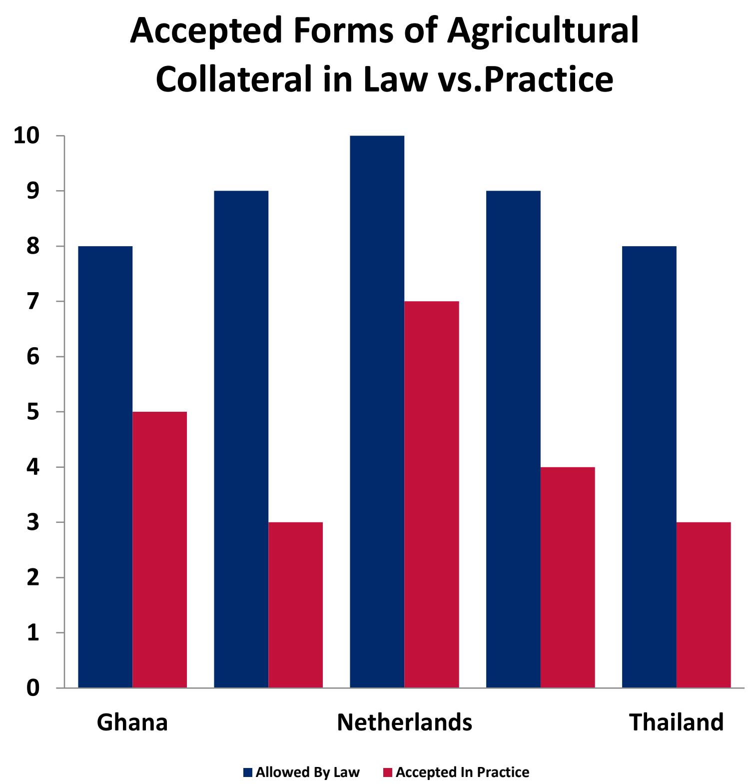
[4] This paper does not purport that collateral serves as an exclusive or singular intervention to boost agricultural finance; it merely focuses on collateral as one facet of a comprehensive solution to a complex challenge. In addition to creating more efficient secured transaction systems, other risk-reduction mechanisms can and should be taken into consideration as part of a reform strategy. For example, technical assistance resulting in producers adopting Good Agricultural Practices that increase resilience, improve yields, and reduce losses, and ultimately makes the farming operations more profitable and lowers risk. Support for improved access to reliable and higher-value markets can also affect the risk profile of an agricultural producer. These interventions can and should be a part of a comprehensive agricultural sector development strategy.

[5] Ouedraogo, Alice, Isabel Caruana, Elsa Rodriguez, and Susann Tischendorf, "It Started in Ghana: Implementing Africa's First Collateral Registry" (2012).

[6] Ibid.

[7] Safavian, Mennaz, Heywood Fleisig, and Jevgenijs Steinbuks, "Unlocking Dead Capital: How Reforming Collateral Laws Improves Access to Finance", World Bank Group (2006).

Legal limitations on what moveable property may serve as collateral create barriers to finance. A legal framework that broadly defines collateral as all forms of movable property, both tangible and intangible, enables borrowers and lenders to determine the form of collateral that grants parties the most flexibility to negotiate terms acceptable to all parties.



Source: USAID AGRI Index

In practice, banks routinely accept fewer forms of collateral than the law permits. For example in Thailand, eight distinct forms of movable collateral exist for the agricultural sector, yet in practice only three forms of collateral are valid, based largely upon specific limits imposed by the government. In Thailand, a pledge can be used for all forms of movable property including tractors, crops, livestock, and inventory. However the regulatory framework requires that the pledged property remain in the possession of the lender to be enforceable, rendering the asset functionally useless. Consequently, banks in Thailand do not routinely accept movable property from agricultural firms as collateral.[8]

Creating an efficient collateral registry

Governments create collateral registries as a means of notification to keep track of all security interests tied to a property or to an individual borrower. A reliable collateral registry alleviates the risk that a borrower uses the same movable property as collateral to secure other loans without the knowledge of the lender.

The importance of a functioning movable collateral registry cannot be overstated. In Albania, a new collateral law and movable collateral registry in 2001 resulted in a 50 percent decrease in the risk premium on lending, the interest rate spread between deposits and loans fell by 43 percent, and the interest rate for loans fell by 5 percent.[9] In addition to reducing the costs of finance, collateral registries also boost access to finance. A survey of companies of all sizes across 73 countries found that the introduction of collateral registries increases access to bank finance by 8 percent and access to loans by 7 percent, with higher impact on smaller firms.[10]

[8] USAID-EAT project, AGRI Index responses from surveys of banks and agricultural borrowers in Thailand.

[9]Ibid.

[10] Love, Inessa, Maria Soledad Martinez Peria, and Sandeep Singh, "Collateral Registries for Movable Assets: Does their Introduction Spur Firms' Access to Bank Finance?," World Bank Policy Research Working Paper 6477 (2013).

Electronic collateral systems offer significant advantages over paper-based systems, both in terms of cost and access. Electronic collateral registry systems have higher upfront costs than paper-based systems, yet the benefits dramatically outweigh the expense of installation and upkeep. Electronic collateral registries can enable simplified filing and lower likelihood of data entry errors. Where multiple registries exist within a country, such as between separate geographic regions, electronic collateral registries enable faster transmission of data between registries, effectively creating a single, unified registry.

Electronic collateral registries also unlock the opportunity for improved access to the registry. Electronic filing capabilities can improve access to rural financial lending, as distant financial institutions can transmit collateral registration documentation remotely and at any hour.

Electronic collateral registries also enable increased transparency within the system, as financial institutions and borrowers can search remotely to ensure the accuracy of pledges filed in the name of the borrower. Based upon a rigorous analysis of historical performance data for 35 secured transactions systems, the introduction of an electronic collateral registry was linked to higher volumes of searches, and increased ratios of searches to loans.[11] A higher volume of searches indicates a significantly higher utilization of credit data and information over less efficient paper systems.

Improving enforcement to enable movable collateral

A strong system protecting enforcement of contract and protection of creditor's rights is an important determinant of private credit market growth and development.[12] This is especially true with movable collateral, whose value often depreciates rapidly over time, requiring clear property rights and efficient enforcement mechanisms. Where banks are uncertain regarding the protection of property rights and the enforceability of contracts, banks adopt more conservative measures to limit exposure, leading to lower-risk lending and higher costs for borrowers.

Based upon a review of 48 countries, the relative strength of contracts enforcement mechanisms and property rights protections has a "statistically significant and economically large" impact on loan terms.[13] Unpredictability in the enforcement of contracts leads banks to shorten maturity, lower total amounts lenders are willing to extend, and lead to higher interest rates for borrowers.

Recent research has raised questions regarding the short-term impact of efficient enforcement mechanisms on smaller firms. In India, specialized administrative tribunals called Debt Recovery Tribunals (DRT) were created to establish more efficient debt recovery procedures for loans in default. The special DRT tribunals created more efficient enforcement mechanisms with clearer, more predictable outcomes for creditors. The development of the DRT tribunals demonstrated positive impact on overall access to finance in India. However, when disaggregated by income levels, it became clear that the cost of capital and availability of capital was reduced in the short term for small rural enterprises. According to the study, financial institutions concentrated their capital in those customers with the greatest tangible assets and away from rural branches, resulting in a regressive outcome.[14]

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[11] Alvarez de la Campa, Alejandro, Santiago Croci Downes, and Betina Tirelli Hennig, "Making Security Interests Public: Registration Mechanisms in 35 Jurisdictions," The World Bank and IFC (2012).

[12] Djankov, Simeon, Caralee McLiesh and Andrei Shleifer, "Private Credit in 129 Countries", *Journal of Financial Economics* Volume 84 Issue 2 (2007).

[13] Bae, Kee-Hong and Vidhan Goyal, "Creditor Rights, Enforcement and Bank Loans," *The Journal of Finance*, Vol. 64, No. 2 (2009).

[14] Von Lillienfield-Toal, Ulf, Dilip Mookherjee, and Sujata Visaria,. "The Distributive Impact of Reforms in Credit Enforcement: Evidence from Indian Debt Recovery Tribunals," *Econometrica,* Volume 80, Number 2 (2012).

RECOMMENDATIONS FOR FUTURE RESEARCH

This brief offers a review of evidence of the potential of movable property as collateral for agricultural loans, as gathered through the work of the USAID-EAT project and by leading authorities, including the World Bank, the International Finance Corporation, and academic luminaries in the study of movable collateral and finance. It is well-established that an effective movable collateral registry is key to unlocking better loan terms for borrowers. On average, improved collateral systems and stronger enforcement mechanisms lower the cost of capital, and boost the availability of finance.

More research is needed to unpack the general equilibrium effects that stronger property rights and more predictable enforcement may have on access to finance for small and rural firms. In particular, more data is needed to understand the applicability of India's example in other contexts. Furthermore, more research is needed to understand the factors driving short-term increases to loan interest rates from the introduction of more efficient and effective enforcement mechanisms. This form of intervention could be well-suited for a Development Credit Authority support function to catalyze short-term rural financial products until the market corrects for new demand among higher-value urban borrowers.

CONCLUSION

Access to finance remains a critical gap for agricultural sector development. With a proper legal and institutional framework in place, movable property can help reduce risks to banks to enable more loans for longer terms at lower interest rates for women and men in the agricultural sector. To encourage sustainable interventions, agricultural finance reform programs should enable improved access to movable collateral to help reduce the risks associated with agricultural finance and to unlock lower-cost financing at better terms.