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### **Role of Secured Transactions to Mobilise Credit and need for mobilizing the law**

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Credit can be classified into two broad categories – one extended by money lenders and the other by banks and financial institutions. On account of very high rates of interest charged by the money lenders and strong-arm methods used for recovery, there is a stigma attached to money lending activity. In the context of credit extended by the money lenders, credit has earned a bad name and evoked comments such as “*Private control of credit is modern form of slavery*<sup>1</sup>; or *Debt is the slavery of the free*;<sup>2</sup> or *Debt is the worst poverty*”<sup>3</sup>. Replacement of money lending system by providing access to the well regulated banking services for the people facing financial exclusion is an area of concern which is being addressed separately and is not within the scope of this paper.

The other lending activity regulated by the Central Banks is undertaken by the banks and financial institutions. The credit extended by the banks and financial institutions is for various economic activities and to cover the credit risk banks are obtaining securities for the credit extended. Modern economists call credit a blessing, a driving force of the economy and an engine for growth<sup>4</sup>. A credit extended, say for buying a truck achieves sale of truck by the manufacturer and also provides a means of undertaking transport business by the person who purchases the truck and pays for the truck in instalments. As far as the probability of default in servicing the credit is concerned, the truck itself can be used as a security which can be repossessed and sold in the event of default. Such a credit is a secured transaction and if an environment conducive to such secured lending is created, it is possible to achieve credit growth.

In most of the emerging economies secured transactions relating to movable property are governed by the general law of contract and there is no specific law for secured transactions. As a result, in such legal systems while security interest of pawn or pledge is recognized, a non-possessory security interest where possession of the security remains with the borrower is not recognized. Further, on account of absence of law, the rights and obligations of parties are not clearly defined and process of realization of security in the event of default takes a long time. In such emerging economies, the small and medium business enterprises operate in a hostile environment facing numerous barriers to entry and growth including credit and insurance market imperfections.<sup>5</sup> They have to operate in structures not recognized by the Government which are controlled by private racketeers. In such adverse environment, small and medium enterprises find it extremely difficult to access credit and lenders also are reluctant to lend on account of risks of default being very high. The overall effect of such adverse environment is that growth of credit is restricted.

Various measures have been tried by emerging economies for the purpose of extending credit to small enterprises and thereby achieve growth. The banks and financial institutions are directed to lend a specified percentage of their total lending to the priority sector which is defined by the Central Bank or the Government. Such directed lending has a moral hazard and is construed as a largesse to the small enterprises of entrepreneurs and track record of recovery of such loans is very poor. Some countries have also tried setting up a credit guarantee corporation to provide a guarantee for defaults in repayment of loans by borrowers which are covered by the priority sector directive. It is also found that such credit guarantee corporations have landed up with claims which are far in excess of the premium collected by them. Since all such efforts to increase the levels of credit in the economy have limited success, there is a

need to find out some alternative to encourage growth of credit in the economy. It is now well established that credit growth can be achieved by introducing a modern secured transactions law which recognizes utilization of the full value inherent in assets to obtain credit.

On the issue of modernization of the secured transactions law, number of efforts have been undertaken. The National Law Center for inter-American Free Trade has adopted twelve principles of secured transactions laws in the Americas. Similarly, the European Bank for Reconstruction and Development has prepared a model law for secured transactions for eastern European countries; and the latest work on the subject nearing completion is the Legislative Guide on Secured Transactions Law which is under preparation by UNCITRAL Working Group VI.

Unique features of UNCITRAL Guide are:

- i) that it has inputs from the experts from member countries and other academic organizations;
- ii) its provisions for recognition and secured creditor rights over secured assets and the rights of enforcement have been coordinated with Working Group V of UNCITRAL which has prepared the Guide on Insolvency Law and;
- iii) the Guide incorporates relevant provisions of UN Convention on Assignment of Receivables.

The UNCITRAL Legislative Guide lists out purpose and objects of the Secured Transactions Law as under:

- (a) to promote secured credit;
- (b) to allow utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of secured transactions;
- (c) to enable parties to obtain security rights in a simple and efficient manner;
- (d) to provide for equal treatment of diverse sources of credit and of diverse forms of secured transactions;
- (e) to validate security rights in assets that remain in the possession of the grantor;
- (f) to enhance predictability and transparency with respect to rights serving security purposes by providing for registration of a notice in a general security rights registry;
- (g) to establish clear and predictable priority rules
- (h) to facilitate enforcement of creditor's rights in a predictable and efficient manner;
- (i) to balance the interests of affected persons;
- (j) to recognize party autonomy; and
- (k) to harmonize secured transactions laws, including conflict-of-laws rules.

While implementing modernization of secured transactions law, any enacting State will have to assess its existing laws and decide whether modernization is to be achieved by amending existing laws or enact a new law. If the enacting State has a Federal structure and powers of enacting secured transactions law is with the States or Provinces, the better course will be to draft a Model law and ask all Provinces to adopt the Model.

Enactment of modern law on secured transactions will also involve some other important policy issues which need to be considered by the enacting States and the same are discussed in following paragraphs.

### **Concept of comprehensive security interest**

The first such policy issue is equal treatment of diverse sources of credit and diverse forms of secured transactions. While the banks and financial institutions give loans against the security over the properties, there are other forms of credit extended by non-banks, which are not treated as secured transactions. A transaction of financial lease, hire-purchase or a sale on credit with a term for retention of title in the assets leased or given on hire or sold on credit, in favour of the lessor, or owner of hired article or the seller. Such transactions are in substance loan transactions inspite of the fact that the form of transaction is a retention of title device and different in form from a loan transaction. One major step required to be taken to introduce reforms in the secured transactions law is to treat all such title retention transactions as equivalent to loan transaction. The consequences of such equal treatment is to confer on the lessor, owner of the hired goods or the seller of the goods rights of a secured creditor and apply all other terms and conditions relating to loan transactions to such transactions. By adopting this policy the sources of credit

will be enhanced and there will be competition amongst the persons extending such credit. Encouragement of such competition would also result in competitive rates of credit for the borrowers. If in any enacting State it is not possible to treat retention of title devices as equivalent to loan transactions, the UNCITRAL Legislative Guide provides an option to treat such transactions as separate, register them and achieve equivalence of retention of title devices with secured transactions, to the extent possible.

### **Widening the range of property rights**

The next policy issue which needs to be considered by the emerging economies relates to recognition of property rights. One of the objectives of modernizing secured transactions law is to allow utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of secured transactions. There are certain types of property rights such as future receivables which are not transferable. If future receivables are treated as property it will be possible to create security interest over such receivables to secure repayment of a loan. (Illustration: A Bank has given a loan for infrastructure project for construction of a bridge over a river. The loan repayment is to be made by collection of toll from the vehicles using the bridge. If future receivables are recognized as a property right, it will be possible to create security interest over the toll to be collected in the future and provide necessary comfort to the lender facilitating credit for such infrastructure projects. For modernization of Secured Transactions Law, the property rights need to be expanded to include wide range of property rights. Importance of recognition of such property rights has been explained by eminent economist Mr. Hernando de Soto in 'Mystery of Capital'. He observes:

“Legal property assigns to assets by social contract, in a conceptual universe a status that allows them to perform functions that generate capital”

“Formal property is more than a system for titling, recording and mapping assets – it is an instrument of thought, representing assets in such a way that peoples minds can work on them to generate surplus value. This is why formal property must be universally accessible to bring everyone into one social contract where they can co-operate to raise society’s productivity”<sup>6</sup>

UNCITRAL Legislative Guide also recommends that deposit accounts, negotiable instruments, rights under independent undertakings (Letters of Credit) may be treated as property rights over which security interest can be created. Enacting States need to consider their existing laws on above property rights and decide whether secured transactions law needs to be extended to property rights which are governed by other independent laws.

As a matter of policy, the States will have to decide the extent to which the property rights will be recognized for the purpose of the secured transactions law.

### **Non-possessory security rights**

Another policy issue which will be required to be addressed by the enacting States is to validate security rights in assets that remain in possession of the borrower. In other words, the States need to recognize non-possessory securities which is usually in the form of hypothecation of goods. Such type of security is most relevant for small and medium size enterprises engaged in any manufacturing activity, which need revolving credit.

### **Registration System**

Another important step in modernizing secured transactions law is to set up a registration system of secured transactions for the purpose of making them effective against third parties and for deciding priorities amongst various claimants over the property. It is preferable that such registration system is operated electronically and made accessible to public so that it becomes a source of information for persons dealing with secured assets. If the registry is made electronic it will be possible for the enacting States to adopt the system of Notice filing with a rule of first to file to get priority. While setting up the registration system, the enacting State will have to take a view on the existing registration system for motor vehicles, IP rights and registry for assets of corporates, and decide whether to continue the existing registries or integrate them with the new secured transactions registry.

### **Standardized terms**

The modernization process needs to recognize party autonomy subject to certain exceptions such as obligation to act in good faith and be commercially reasonable while exercising powers of enforcement of security in the event of default. To facilitate secured transactions the standard terms containing rights and obligations of parties can be provided by Law which will apply in the absence of contract to the contrary.

### **Prescribe rules of priority**

The law needs to provide an efficient and predictable regime to decide priority of a security right. While it is necessary that the Law recognizes priority to secured creditor over all other claimants, if there are any preferential rights for Government revenue or workmen's dues, the same should be clearly provided so that there are no uncertainties as far as security rights are concerned. Such rules of priority will have to be recognized by the Insolvency Law.

### **Confer powers of enforcement**

The most important part of secured transactions law is rights of enforcement to be conferred on the secured creditors. Strong recognition of such rights provides comfort to lenders and reduces the risk of default. If the judicial system in the enacting State is efficient and it is possible to recover defaulted loans expeditiously, no reform may be necessary. But if the system is not efficient, there is a need to empower the secured creditors to enforce securities without the intervention of the Courts (power of foreclosure or self-help) or reform the judicial procedures to facilitate speedy recovery.

### **Conflict of Law Rules**

While modernizing the law, it will be necessary to determine the law applicable to following issues:

- Creation of security right
- Pre-default rights and obligations
- Effectiveness of security right against third parties
- Priority of security right
- Enforcement of security right

### **Transition Provisions**

When it is decided to modernize secured transactions law, it is advisable to fix a future date for the law to become operative to facilitate adjustment to the change in law by all affected parties. The provisions can also be enacted stipulating the procedure for transition for the existing loans for which security interest is created to be covered under the new law.

In conclusion, it may be stated that modernization of secured transactions law will mobilize credit and growth of credit activity in the economy will facilitate establishment of potentially efficient small businesses. Creation of environment conducive to credit growth and removal of barriers to access credit will result in transformation of small and informal businesses into large and formal ones.

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