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The Right to Borrow

Legal and regulatory barriers that limit access to credit by small farms and businesses

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When World Bank staff design credit programs in developing countries, they often find that lenders in the formal banking sector show little interest in small farms and businesses. Although their reluctance to lend is especially great for very small operators, such as artisans, street vendors, and subsistence farmers, surprisingly, it extends even to more substantial operations with several employees. Many explanations for this behavior have been posited, including banks' innate conservatism, the high unit costs of small loans, class differences between bank officers and small borrowers, excessively conservative bank regulation, and excessively loose bank regulation that permits bank lending to related parties, crowding out the smaller, presumably unrelated, borrowers. But another important explanation for this lending behavior lies in the laws, regulations, and institutions of these countries. Though these may often spring from efforts to protect unwary borrowers or the poor, they can instead force borrowers out of the formal banking system and into the hands of the very lenders from whom they were supposed to be protected. This Note, based on the results of Bank analysis, shows how such legal, regulatory, and institutional barriers limit access to credit.

Barriers arising from protecting borrowers

Many countries have specific laws and regulations that are intended to protect borrowers:

Homestead and exempt property provisions

All countries limit the ability of creditors to take property from debtors unable to service their debts. So, for example, no country whose lending laws were analyzed permits a creditor to seize a debtor's shoes or bed. Some countries also set a minimum amount of real estate that is exempt from seizure—the "homestead." This protection has a cost: if the land cannot be taken from the debtor, banks will not accept it as collateral. In a well-supervised banking system, examiners will regard borrowers offering such collateral as unsecured. For such unsecured loans, bank regulations require more capital or provisioning by the bank. That raises the cost of making these loans, and, because they usually are also riskier and smaller, banks find them unprofitable.

Other legal provisions limit the amount or type of movable property that a creditor can take from a debtor—exempt property. For example, the law may contain provisions limiting the

creditor's ability to take tools of trade from the debtor. Unless carefully drafted, such legal provisions can make lenders unwilling to make productive loans to small borrowers. Because the lender knows that the equipment to be purchased—a new sewing machine or wood lathe, for example—will be pooled with the borrower's exempt property, the lender is aware that it cannot be repossessed and sold and will not accept it as collateral for a loan.

Usury laws

Many countries limit the interest rate charged on loans to protect unwary borrowers from unscrupulous lenders. In practice, however, high interest rates are often justifiable. Many of the costs associated with a loan are fixed, and these fixed costs represent a higher percentage of a small loan than of a larger loan. Since operators of small farms and businesses are more likely to want a small loan than are operators of large farms and businesses, private lenders charge higher interest rates to small operators than to larger ones. The lender would ordinarily hope to recover these larger costs with some combination of higher interest rates and an up-front loan processing charge. In addition, the costs of monitoring small, unsecured loans are higher than those of monitoring larger, secured loans. A lender with a small, unsecured loan must regularly inspect the borrower's business premises to be confident that the business is still solid, while secured lenders know that they have the right to take property with some value even if the business is not solid. Finally, the risk associated with small loans that are unsecured can be higher than the risk associated with large loans that are secured. To compensate for the higher costs and risks of small, unsecured loans, private lenders could be expected to charge higher interest rates.

Private lenders do in fact charge high rates on unsecured loans. In Bolivia, for example, where the rate of inflation is less than 10 percent, interest rates amount to as much as 48 percent a year on small, unsecured loans made by nonprofit lenders with access to funds at zero interest. Rates run 70 percent a year on loans by unsubsidized public interest lenders attempting to cover their costs of operation. These rates may seem high and perhaps prompted the 3 percent per month usury limit in Bolivian law. But private borrowers operating small farms and businesses can face even higher implicit interest rates in the course of doing business. A street vendor in La Paz reported being charged 300 bolivianos in cash for a case of crackers or 310 bolivianos if she paid three days in the future—an implicit interest rate of more than 5,000 percent a year on the cost of carrying this part of her inventory.

For such a borrower, obtaining a loan at 4 percent interest per month from a nonprofit lender would result in annual interest savings equivalent to a substantial share of her income. Clearly, a usury law that limits loans to low interest rates just forces poor borrowers into other markets where usury laws are not enforced—thereby increasing the interest charges and making the poor worse off.

Solutions

Change the law to limit the homestead provision to a size of holding that balances protection against seizure with the economic cost of loss of access to loans and the landowner's freedom to contract; limit exempt property protection to clearly defined sets of goods and amounts of money and clearly distinguish between the existing stock of goods and goods newly purchased on credit; replace usury laws with laws requiring the disclosure of true annual interest rates and requiring that loan contracts set out their general implications in clear language.

Barriers that effectively discriminate against the poor

Many laws and regulations not specifically directed at the poor nevertheless have an important impact on them—and can sometimes be discriminatory in effect.

Limits on using equipment and inventory as collateral

Barriers to using movable property as collateral limit access to credit. This especially penalizes operators of the smallest businesses who have only human capital—their heads, their hands. Typically, they also need to acquire movable capital—tools, transport equipment, merchandise inventories—to perform their work. To purchase this equipment on credit, small operators must be able to make a down payment and have the equipment itself serve as collateral, especially if they have no real estate to offer as collateral. Loans secured only by a personal guarantee often are too small and too expensive to finance productive equipment such as farm machinery, a taxi or microbus, or the inventory of a small store.[1]

Limits on using accounts receivable and loans as collateral

Operators of small farms and businesses get credit from many sources without offering collateral. Equipment dealers may sell them parts and small machines on credit. Dealers in fertilizer, herbicide, and seed may extend credit over the growing season. And wholesalers often extend short-term credit to retailers. These dealers can become essential sources of credit for unsecured borrowers because they get to know their customers well in the course of ordinary, noncredit transactions. Because getting good information about the behavior of these small borrowers is one of the largest expenses in determining their creditworthiness, nonbank creditors often have a large cost advantage over banks in supplying credit to them.

But nonbank businesses face the same difficulties as their customers do in getting access to credit. They typically are unable to use their holdings of movable property—their inventory, their stocks of new and used machines—to secure loans from banks. Limits on the dealer's ability to get credit put limits on the dealer's ability to give credit, breaking the chain of credit that could link the small borrower to the banks.

As important in breaking the chain of credit is the difficulty nonbank lenders often have in using the credit they extend to their customers as collateral for loans from banks, either through accounts receivable or chattel paper financing. While formal sector banks may not be interested in making loans of less than $100 to operators of small businesses and farms, they could fund the refinancing of the businesses that make these loans quite lucrative. In the United States and Canada, for example, far smaller loans represented by credit card receipts are bundled together to secure commercial paper flotations that can amount to hundreds of thousands of dollars. When dealers and nonbank lenders can refinance the credit they offer, the supply of such credit expands and its cost falls. But expanding such financing requires a secured transactions law that permits easy, inexpensive public registration of security interests in accounts receivable or in chattel paper, and inexpensive transfer of these accounts if the borrower (the dealer or nonbank lender) defaults. Otherwise, these dealers and nonbank lenders will find it impossible to raise enough money to fund the loans they otherwise could profitably make.

Other legal and regulatory requirements

Other legal and regulatory requirements can discriminate against the poor by limiting their access to credit. Laws intended to protect minors by limiting their ability to sign binding contracts will force the heads of households of many poor families to turn to informal sector lenders. And creditors willing to make such contracts will be hampered in using them to get credit from the legal sector.

A requirement that loan contracts must be in writing and signed by the borrower can create a hardship for poor citizens who are illiterate, who cannot read and write in the language used by the banks, or who are blind.

Solutions

Reform the framework for secured transactions, especially with respect to the cost of transfer-

ring the accounts of the account debtor, the registration of security interests in those accounts, and the collection of the accounts of the account debtor if the borrower cannot pay the loan secured by those accounts; carefully assess the costs and benefits and the public policy implications of the age of majority; change the law to conform to that cost and benefit calculation; consider alternative forms of contracting, including using fingerprints as signatures and witnesses to cosign as evidence of assent.

Institutional issues

Institutions give force to the law. Sometimes those institutions operate in ways that frustrate the law's intent.

Registries

Many of the lending instruments discussed here require public registration. Public registration is crucial because each lender needs to know whether any prior security interest in the collateral exists—for example, another loan that must be paid first from the proceeds of the sale of the collateral. A $100,000 house might appear to be adequate collateral for a $50,000 loan. But if the house already had a mortgage of $80,000 against it, which would have to be paid before the $50,000 loan, it would not be adequate collateral. A registry system that is open to the public and inexpensive to search makes it easier to determine the priority of security interests and thus the riskiness of a loan. Yet in many countries, registries can be searched only with official permission that is difficult to obtain, and sometimes registries are organized in ways that make a search technically difficult.

Credit information

Operators of small farms or businesses may not own land or movable equipment, but they could still establish a reputation for honesty and timely payment of debts. Their access to credit will expand if they can make their reputations known beyond the small circle of dealers and merchants with whom they deal. A credit reporting system that pools information about borrowers permits the poor to "capitalize" on their reputations by persuading other lenders to lend to them without security. It also reduces the risk in unsecured lending by making credible the threat that a creditor could spoil the reputation of an unsecured borrower who did not pay a debt.

Solutions

Improve state-run registries by restructuring them, decentralizing them and introducing competition, or by privatizing them; regulate public access to credit bureaus so that information collected can be distributed to interested parties; design a legal framework to allow people to challenge inaccuracies in information held by the credit bureau.

Conclusion

Many problems in access to credit arise from defects in the legal, regulatory, and institutional framework for extending credit. Bank projects aimed at building institutions and extending credit lines to enhance access to credit for operators of small farms and businesses will have greater impact when these larger issues are also addressed.

This Note draws on World Bank projects in Bolivia and Bangladesh undertaken under the broad supervision of Vicente Fretes-Cibils, Jonathan Parker, Susannah Knaudt, and Madhur Gautam. The findings represent the work of a team that included Ronald C.C. Cuming, Nuria de la Peña, Ulrich Drobnig, Alejandro Garro, Lance Girton, Graciela Rodriguez-Ferrand, Stephen Salant, Harry Sigman, and John A. Spanogle. Papers describing the projects in greater detail are available from the author.

[1] FPD Note 43 details the legal and regulatory roots of the inability to use movable property as collateral.

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