COLLATERAL IN RURAL LOANS

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PREFACE

The Association of Latin American Development Finance Institutions (ALIDE) and the Food and Agriculture Organization of the United Nations (FAO) have been jointly implementing a Partnership Programme on the subject of "**The Role of Collateral in Rural Loans**", which was carried out in three phases between late 1993 and 1995.

The first phase involved the collection of basic information on instruments and policies as related to the role and the importance of collateral in agricultural and rural loans in ten Latin American countries and resulted in a global study.

The second phase consisted of a case-by-case analysis of specific selected collateral instruments and systems used by development finance institutions in the region's countries. An evaluation was made of the most salient aspects of the collateral employed for agricultural loans.

The third phase of the ALIDE/FAO Cooperation Programme comprised the preparation of this document, which incorporates the substance of the studies and analyses made during the first two phases of the Programme under the responsibility of the consultant, Nicolás Velásquez R. Also used were contributions on other experiences considered important for the management of collateral in agricultural loans, particularly for small farmers and they include both personal and real unconventional collateral.

It is recognized that collateral is vital for the growth of formal credit markets for in particular smallholder farmers. This document takes up the legal and economic characteristics of collateral and examines the main collateral types used in rural credit by development banks. Also explored are new forms of collateral recently developed, mainly by Non-Governmental Organizations (NGOs) and some new banks specialized in providing loans to small producers, and the way how these guarantees can be adopted by development banks.

Collateral has legal and economic attributes. From the legal point of view, it protects the rights of the lender and ensures the compliance with an obligation. From an economic viewpoint, collateral makes it possible to overcome or to reduce the problems of imperfect information which characterize loan transactions.

Collateral can be personal or real. The former is related to the wealth of the borrower or of his guarantor or co-signers, while in the latter case a specific asset is committed for the value of the loan principal and interest payments. Banks, have mostly favored the use of real collateral --preferably mortgage-- to secure their loans. Mortgage collateral, however, generally discriminates against small farmers, since many of them do not have secure land titles or the land they own has little commercial value. In view of this situation, development banks have used pledges of agricultural assets as the most common type of real collateral.

Even so, pledging is not completely satisfactory, since problems have arisen in the appropriation and execution of the pledges. Furthermore, it has not been possible to finance non-agricultural production activities which are very important for small rural producers. As a result, several development banks have looked for new forms of collateral, like guarantee funds or crop insurance.

At the same time, other institutions like NGOs and some new banks specialized in providing loans to small producers, have had success with another kind of personal and real collateral, known as unconventional collateral. Among this type of collateral are the endorsement of the organization to which the producer belongs, joint and several liability, group solidarity funds, blocked savings, and unconventional pledges. Several of the experiences with unconventional collateral that are analyzed in this study, suggest that their use in loan operations offers positive prospects to development banks, enabling them in this way to broaden their loan coverage of small rural producers.

The consultant Javier Alvarado G., assisted by María Alvarez M., collaborated in the preparation of this document,[1]. which corresponds to the third phase of the ALIDE/FAO Cooperation Programme. Rommel Acevedo F. De P., Head of the Technical Department of the General Secretariat of ALIDE, assisted by Walter Torres Kong, Head of the Economic Studies Section, was responsible for the supervision and general coordination of the Programme. From FAO, Richard Roberts and Anthon Slangen, of the Marketing and Rural Finance Service participated actively on behalf of their organization.

[1] This document is available in English and Spanish (original) and can be obtained from both ALIDE and FAO.

EXECUTIVE SUMMARY

The presence of risk in loan transactions, above all in the agricultural sector where this factor is even more important, underlines the fact that the outreach of financial services is influenced by the collateral that borrowers can offer. A deficiency in or an absence of collateral impedes the entry and deepening of formal credit services in the rural environment, thereby limiting the development possibilities of this sector.

From a legal standpoint, the establishment of collateral means that the lender is assured of recovering, if necessary by court action, the material value established in a given transaction.

From an economic viewpoint, not just any asset is able to serve as collateral for a loan; ideally, collateral should fulfill five basic attributes: (i) be appropriable; (ii) be saleable or able to be converted into money in order to cover the loan obligation; (iii) create a sense of or constitute a loss to the borrower; (iv) be durable or sustainable during the loan contract time; and (v) have transaction costs that are accessible to borrowers, both with regard to the loan amount and the terms of the loan.

Collateral for rural loans can be classified both from the legal standpoint as well as in terms of its acceptance and use by development banks. In the former case, a distinction can be made between personal and real collateral. Personal collateral refers to the solvency of the debtor or of third parties who stand in for the debtor; theoretically, all the assets belonging to the borrower or to the third party guarantors secure the debt. Real collateral refers to specific assets that secure loans.

From the viewpoint of its acceptance by development banks, collateral can be classified as: conventional collateral and non-conventional collateral. The former refers to collateral that normally has been accepted as security by development finance institutions that lend to the rural sector. This type of collateral consists of both personal collateral and real collateral. Among conventional personal collateral are endorsed loans and third party guarantors, while the most used real collateral is the mortgage (of land) and the pledging of agricultural assets. Other mechanisms like guarantee funds and agricultural insurance have also been used.

Non-conventional collateral can be as well personal or real. Non-conventional personal collateral is also known as social collateral and is based on the use of specified rules, incentives and penalties within existing organizations or those which are created ad hoc for the loan transaction. The most important forms of social collateral are the endorsement of the group to which the borrowers belong and of solidarity groups with joint and several liability. Among the types of unconventional real collateral are the pledges of assets not generally accepted by development banks (such as **criollo** or mongrel livestock, small animals, household electrical appliances, etc.) and the so-called group solidarity funds. Mechanisms such as customer graduation and interlinked or trade related credit also function as non-conventional collateral. This latter procedure is used primarily by informal lenders.

Conventional Collateral

Endorsement (Surety-backing)

This is a kind of collateral that can be constituted fairly easily through the signing of documents in which the borrower or a third party places on record the security of the loan, which entails low transaction costs for the borrower. It does, however, introduce additional costs for lender, for if the endorser has no proper credit record or is not an institution of proven creditworthiness, the capacity of the endorser to repay the loan will have to be assessed.

In rural loans, particularly those granted by development banks, the use of endorsement is not as common as it is for commercial banks. Development finance institutions that have used third party surety-backing generally have done so to supplement other types of collateral.

Third-Party Guarantee

As in the case of surety-backing, this guarantee is easily constituted and involves low transaction costs for the borrower, but not for the lender, who must evaluate the guarantor's solvency. As in the case of surety-backing, this collateral has the disadvantage of depending on the wealth of the guarantor. However, unlike it, the lender can bring suit against the guarantor only after he has exhausted all other legal means of recovering the loan sum owed by the borrower. This third party guarantee arrangement has been used even less than surety-backing by development banks.

Mortgage

Mortgage has the advantage of constituting a clear and transparent collateral for the lender. Normally, mortgaged land has the attributes of appropriability, it can be sold, it lasts over the time and it creates a great sensation of loss to the borrower, especially since land is generally the main and often the only means of production of the small rural producer. In these circumstances, when the borrower mortgages his land, he normally does everything in his power to repay the loan; in extreme cases, the lender is able to recover his capital and interest without incurring overly high costs.

The different laws governing Latin American development banks provide for mortgage as possible collateral for securing a rural loan. Its greatest drawback, however, is that it is generally not accessible to the small rural producer, because property rights have not been fully defined. In many areas, the producer has the right to use, but not to transfer, the land; the process of securing land titles is long and costly. Furthermore, mortgage generally entails high transaction costs for the borrower. The result of all of this is that this type of collateral is used mainly only in large loan contracts, that bear relation with the mortgage costs. Farmers, however, and especially small producers, generally request small loans that do not justify the high costs of establishing a mortgage.

Pledging of Agricultural Assets

The main advantage of the use of pledging movable assets is that almost all rural producers own some asset or crop that they can offer as security. Moreover, almost all assets that can be pledged are salable.

Given the difficulties of establishing mortgage collateral, Latin American development banks have placed great emphasis on the use of agricultural pledges as the main collateral for rural loans, particularly for small farmers. Nonetheless, experience with the use of this type of collateral has revealed the existence of problems of appropriation and sustainability. In the former case, the transaction cost for executing the appropriation of the pledged asset are very high. Sustainability is uncertain, inasmuch as the pledged assets are subject to multiple risks due to climate, theft, fraud or deterioration, above all in the case of crops and livestock.

Guarantee Funds

These are funds constituted by borrowers or third parties (State, NGOs, Church) with the purpose of reducing or eliminating the lenders' loan portfolio risks and of replacing or supplementing the demand for other real collateral. It is only recently that guarantee funds have begun to be used as collateral for obtaining rural loans, mainly by development banks, either as an alternative or a supplement to the use of mortgage or pledges of agricultural assets.

Guaranty funds operate like supplementary real collateral and have the advantage of appropriability and access to liquidity funds from which the lenders can cover the risks of the loan transactions. However, when the guarantee funds are created by the state or third parties, there is a danger that the producers see that their defaults are covered from those funds with no consequences for themselves. There is the additional danger that financial institutions will not exercise an adequate loan management, since they trust that the guarantee funds will ensure their loan defaults.

Agricultural Insurance

Agricultural insurance does not constitute a collateral in itself, as the insured party of a calamity is the producer and not the financial institution. Even so, in several of their credit schemes, development banks are using insurance against various types of weather catastrophes as a prerequisite for the provision of farm loans. This type of mechanism, as in the previous case, seeks to supplement or replace the demand for real collateral from rural producers.

A problem with insurance is its viability and high costs, since agricultural production activities are exposed to high risks.

Non-Conventional Collateral

Non-Conventional Pledges

Conceptually speaking, non-conventional pledges do not differ in their definition or attributes from the pledges of agricultural assets. The difference lies in the kind of asset that is pledged. In this case, what is pledged is criollo or mongrel livestock or smaller animals (pigs) and household electrical appliances, that are normally not accepted as pledges by commercial banks or development finance institutions. Non-conventional pledges have the advantage that most rural producers possess goods that can be used to constitute this kind of collateral at no great transaction costs to the borrower. However, they do share several of the drawbacks of conventional pledges.

Common Group Funds

Group funds are a type of collateral that combine the mechanism of solidarity groups with that of guarantee funds. Each one of the members of a solidarity group contributes resources (generally money) to a common fund that serves as collateral for loans to all group members. This fund is deposited into an account that is blocked by the lender, so long as the loan contracts are in force and may be used only to recover unpaid loans. This account usually earns the normal interest rate paid on savings accounts. These group funds have the attributes of being appropriable, easily executable and create a sense of loss to the borrowers. Their sustainability is closely related to sound macroeconomic policies with regard to inflation control.

Blocked Savings

Blocked savings are savings that the potential borrower gradually but continuously deposits into an account, until a certain amount has been accumulated that will serve as collateral for a loan. Once the loan is made, similarly as in the case of the group funds, the savings will remain blocked or frozen, while earning interest until the loan has been fully repaid. This collateral is generally supplemented by other securities, inasmuch as the rural borrower is unable to save much.

Solidarity Groups

This collateral mechanism forms part of the methodology of numerous experiences of new credit technologies to rural and urban small and microentrepreneurs. These persons constitute groups to have access to loans and often also training services. The members of the group collectively secure the debt service, and the access to subsequent loans depends upon the prompt repayment of the previous loans by all group members. The loans can be granted to the group as a whole or to each member individually and the repayment obligation can be assigned to the individual members or to the entire group.

Endorsement by Grassroot Organizations

This type of collateral is equivalent to personal collateral. In this case, the financial institutions request the endorsement of the organization to which the borrower belongs, as a means of replacing the required information about the borrower's creditencials and his willingness to repay. It operates well for the selection of borrowers and loan collection, but not for the monitoring of loans when there are a large number of members in the organization. This type of collateral is generally supplementary to other kinds of security and is based on the advantage of economies of scale in information costs through grassroot organizations.

Graduation

Under this system, the lender allocates a small amount of money in the form of loans to producers, who request credit for the first time. Once the borrower repays the loan at the stipulated time, he is automatically promoted to a higher category, thereby entitling him to a larger loan. This system is applied only up to a certain loan limit and is based on the appreciation of the loans by the borrowers and on their perception of the durability of the loans and the commitment of the lenders to increase future loans.

Interlinked or Trade Related Credit

This modality is used by traders. A loan is granted, tied to another trade related transaction between the lender and the borrower; the terms of both transactions are generally set at the same time. Faced with a failure in the main trade transaction, the lender can take normally only action with regard to future loans and trade related transactions.

1. INTRODUCTION

Credit is vital to a country's economic development, if one bears in mind that deepening and widening of the financial markets make it possible to enlarge the markets for commodities, services and production factors. In a market economy, the interest rate fixed in financial markets contributes to an optimum resource allocation. And from the family household viewpoint, financial intermediation services like savings and credit allow families to efficiently cope with their farm/household expenditures and risks they face, and in this way credit may contribute to their general well-being.

Given the importance of credit to development, the efforts that governments of developing countries have made to introduce and enlarge formal financial systems are not surprising, above all in the most backward zones such as in rural areas. Despite the large amounts of credit granted, however, the efforts have not yielded the expected results. This is due, for the most part, to erroneous credit policies. Controlled, and in particular subsidized interest rates and, in general, populist lending policies that prevailed in Latin American countries up to the past decade, have impeded the development of viable rural financial markets.

Today, conditions have changed considerably. Economies have been opened up to market forces in different degrees in almost all of the countries. Financial reforms have been carried out and it is recognized that markets, and not bureaucrats, should set interest rates. In short, the macroeconomic environment is much more favorable now to the development of rural financial markets.

Nonetheless, in order that lending in particular to small rural producers will increase, it is not enough to have a favorable market environment. As we will see further ahead, the nature of credit transactions reveals that collateral is an extremely important element in expanding credit. The absence of collateral is a factor that impedes the establishment and deepening of financial markets. Without an adequate collateral system, it will be impossible for strong, viable financial institutions to emerge. Therefore, solving or reducing the problem of loan collateral will undoubtedly help to expand rural financial markets.

In the rural sector, particularly in zones of small producers, the absence of collateral is a pressing problem. Most small producers do not possess assets that commercial banks are willing to accept as collateral. In view of this situation, development banks have used alternative forms of collateral, primarily consisting of so-called agricultural pledges. While these systems have helped to expand credit to small producers, they have had the disadvantage of neglecting the financing of non-agricultural rural activities which are very important for low-income producers. Furthermore, pledges of agricultural assets have frequently been insufficient to ensure full loan recovery, thereby impairing the viability of the development finance institutions.

This situation has led various institutions in different parts of the world to develop new collateral systems, known as non-conventional collateral. These allow the financing of all production activities of small rural producers and ensure loan recovery in such a way that financial institutions can become self-sustainable and continue operations.

The purpose of this document is to analyze the different forms of collateral that have been used for rural loans, primarily to small producers. In this way, the collateral systems that are best suited to those producers as well as to the financial institutions are examined in order to understand which ones can be adopted by development banks.

The paper is presented in the following way: In the first section, the legal and economic aspects of the different types of loan collateral are analyzed. The second section takes up the various types of collateral used for rural loans, and focuses on their salient characteristics and the experiences of applying them in the rural environment. Finally, the conclusions of the analysis are presented. The work includes also an annex which briefly describes some successful international experiences of non-conventional loan collateral that have been used in lending to small rural producers together with a table of statistical data.

2. LEGAL AND ECONOMIC ASPECTS OF COLLATERAL

2.1 Legal Aspects.

a) Definition.

From a legal standpoint, collateral is defined as the general protection that the legal system gives to individuals in exercising their contract rights --and, more specifically, the means it gives the lender or creditor to execute his claims for recovery of loans from the borrower or debtor. The establishment of collateral within a legal relationship[2] aims to secure the lender's right to recover, coercively if necessary, the material value established in a loan transaction.

A collateral is a deposit, a pledge, a mortgage and, ultimately, anything that can serve as a guarantee and may ensure the compliance with an obligation or promise. Legally, collateral is synonymous with security and it is precisely this that interests the lender or the active subject of an obligation: that the performance of a loan obligation be ensured so that his right is not merely illusory and nominal.

b) Legal nature.

All collateral is accessory and subsidiary to the primary obligation, which compliance it attempts to ensure. As an accessory obligation, it can neither exceed the secured obligation, nor survive it.[3] Collateral accompanies a credit right and serves to strengthen the position of the lender in his legal relationship with the debtor. The termination of the primary obligation determines the termination of the collateral.

With the evolution of legal relationships, the debtor's solvency was not considered sufficient to ensure his future performance; it then became necessary to complement this with another guarantee. This can be of a personal nature, when a third party commits himself to pay a guarantee in case the debtor does not fulfill his obligation; or of a real nature, when the debtor or a third party encumber part of their net assets to secure the compliance with a loan obligation. Thus, in Rome, side-by-side with the third party guarantees, various types of real collateral emerged, with the appearance, successively of the trust fund, the pledge, the mortgage and the antichresis. But if the origin of the distinction between these legal figures is to be found in the Roman Law, the progressive individualization of collateral to their present state of substantiality and autonomy in the legislation of different countries, results from a long historical evolution.

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[2] A legal relationship is any relationship that is sanctioned by a legal norm, that enables to coercively demand the compliance with an obligation as stated in the contract.

[3] J. Castañeda. El Contrato de Fianza. Talleres Gráficos Tip. El Ferrocarril. Lima, 1965.

Legally, the different manifestations of collateral can be distinguished into three forms: First, the asset leaves the owner's material possession and passes into the power of a third party or of the lender, empowering the latter to sell that asset if the obligation is not duly fulfilled. Second, the collateral consists of assets that do not leave their owner's possession, but the lender can demand their sale if the obligation fails to be performed. Third, the lender acquires the right to get the benefit of the fruits of the asset that has been offered as collateral or to receive a part of the benefits to pay off the loan, either by transfer of the asset to the lender's possession, or by depositing it into the hands of a third party or by leaving it in the owner's possession.[4]

2.2 Economic Aspects of Collateral

a) Nature of the Loan.

Loan transactions are characterized by their intertemporal nature. The transaction begins when the borrower applies for the loan, continues with his acceptance as credit subject, is followed by the loan disbursement, and concludes when the lender collects the loan amount with the corresponding interest charges. Throughout the entire process, there is an element of trust that makes the transaction possible. As Carlos Díaz-Alejandro points out: "The loan transaction includes a promise of repayment in the future, which may or may not be fully believable. This demands the proof of an interpersonal trust... ."[5]

The interpersonal trust that should exist between lender and borrower for the granting of a loan, demands the existence of a considerable amount of information between these two agents. Nonetheless, to acquire that information is costly and imperfect. This means that the lender does not have full and exact information on the borrower's capacity or willingness to pay and to obtain this knowledge will be prohibitively expensive. The problem of imperfect information appears in the three phases of the loan process: in the borrower selection, at the incentive stage to properly use and repay the loan, and in the recovery of due loans.[6] These three phases constitute what is known as credit technology.

In their selection, lenders do not know the probability of non-repayment of each subject who applies for a loan. Once the credit has been granted, it is difficult and costly for the lender to ensure that the borrowers will take actions that favour the payment of their loans; this is the incentive stage. Finally, in the event of a default, it is costly to determine if this was due to situations outside the borrower's control or whether it was the result of a deliberate action.

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[4] Román Sánchez, cited by Ignacio De Caso and Romero and Cervera and Jiménez-Alfaro. Diccionario de Derecho Privado. Labor S.A. Publishers, Barcelona, 1950.

[5] See C. Díaz-Alejandro: "Good-bye Financial Repression. Hello Financial Crash" in Journal of Development Economics. September 1985.

[6] A more thorough analysis of the problems of imperfect information can be found in J. Stiglitz and A. Weise: "Credit Rationing in Markets with Imperfect Information" in American Economic Review, June 1981; and in K. Hoff and J. Stiglitz "Imperfect Information and Rural Credit Markets: Puzzles and Policy Perspectives" in The World Bank Economic Review, September 1990.

b) The Role of Collateral in Imperfect Information.

It is in this context that collateral appears as a factor that helps to solve the problems created by imperfect information. In the case of borrower selection, given the difficulties of the lender in determining the repayment capacity, collateral emerges as a visible element that is linked to that capacity.[7] Normally, the larger the value of the collateral, the greater the expected payment capacity. In this way, collateral acts, in the selection of borrowers, as an element that discriminates against small producers because of their difficulties in providing collateral; whenever they are able to do so, the value of their collateral is not very large.

In the incentive phase, collateral acts as a mechanism that indirectly influences the borrower's behaviour in taking actions that are favorable to loan repayment. The more valuable the collateral of a loan, the more willing the borrower will be to take actions that are conducive to repayment of his debt.

In the loan recovery phase, the threat of loss of collateral is a mechanism that directly influences the timely repayment of the loan. As in the previous cases, the value of the collateral is positively related to the loan recovery.

c) Characteristics of Loan Collateral.

Nonetheless, not just any asset can serve as collateral for a loan. In ideal terms, a collateral should fulfill the following five basic attributes:

i. Be appropriable.
ii. Be salable or have the possibility of being converted into cash to cover the loan transaction.
iii. Cause a feeling of, or constitute a, loss to the borrower.
iv. Be durable or sustainable during the contract time.
v. Entail transaction costs that are accessible to the borrower and directly relate to the loan amount and terms.

The better an asset complies with these characteristics, the greater will be its capacity to serve as collateral.[8]

Generally, private formal credit institutions require collateral that secures loans in accordance with the five above-mentioned conditions. Nonetheless, as we will see further ahead more in details, for other types of loans, assets that meet only some of these five requisites can act still efficiently as collateral. Of these, the condition that is essential is the feeling of loss that is associated with the establishment of a collateral.

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[7] There are obviously other "visible" elements that lenders, above all formal lenders, use to obtain information on the payment capacity of a potential borrower. Some of these are the borrower's credit history, changes in current and/or savings accounts, etc.

[8] The term <u>asset</u> is this definition refers not only to physical goods, but includes also all goods that generate a benefit to the borrower.

Appropriability refers to the possibility of transferring possession of a given asset from the borrower to the lender without entailing excessive transaction costs.[9] Appropriability implies that the asset which constitutes the collateral has well-defined property rights and that legal and social mechanisms exist that allow transfer of the asset without having to incur exorbitant high costs.[10]

The asset that constitutes the collateral must be salable or be able to be converted into cash in order to cover the loan transaction; tradeable goods and personal collateral are included. This means that a market for that asset should exist, which allows its valuation. It is important not only for setting the price for a collateral, but also because, in the event of loan default, the lender generally does not need to remain permanently in the possession of the asset, but he can sell it to recover the loan value.

The feeling of loss refers to the value that loss of the asset given as collateral represents to the borrower and it is also related to the lender's perception of this valuation. In this context, an asset may operate as collateral, if it has a high value to the borrower and, in case the lender perceives that the borrower values significantly the loss of the asset.

The condition of durability or sustainability of a collateral during the contract period means that in order to fulfill its function as collateral, an asset must not expire and it should keep also its value; otherwise, its expiry or wear and tear would leave the loan transaction unsecured.

The expenses of formalizing assets as collateral must be accessible to the borrower. In other words, an asset that serves as security must have transaction costs that are reasonable for the borrower and also be in proportion with the loan amount; otherwise, these expenses will impede the conclusion of the loan transaction.

The many functions that a collateral must fulfil in order to secure the compliance with a loan obligation, mean that a single asset may not be able to fulfil all of them. It is for this reason that for most transactions a lender requires several assets to ensure fulfillment of all of these functions.

Furthermore, appropriability, marketability, valuation and transaction costs to the borrower are all characteristics which are institutionally and socially determined. This means that the quality of an asset as collateral is not absolute, but depends on the economic and social context in which the loan contracts are situated. In other words, an asset that in one specific situation presents a perfect collateral, in another one may be unusable as security. Land is an example of this. It is a highly valued collateral in case of private land ownership together with a legal and social system that enables land transfer and given the existence of a land market. However, in case there is no private property system and the legal and social systems do not support the transfer of land, then it will be difficult that it can serve as loan security.

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[9] For a more comprehensive analysis of appropriability, consult S. Floro and P. Yotopoulos: Informal Credit Markets and The New Institutional Economics: The Case of Philippine Agriculture. 1991, Westview Press.

[10] To broaden the analysis of property rights, consult Y. Barzel: Economic Analysis of Property Rights. 1989. Cambridge University Press.

d) Collateral and Interest Rate.

Collateral has a relative close relationship with interest rates, inasmuch as both interest rate and collateral value have a positive effect on the expected income of lenders. In that sense, a high interest rate and low collateral value can provide an expected income similar to that of a low interest rate and a high collateral value. Along this same line of reasoning, several investigations demonstrate **ceteris paribus**, mathematically and empirically, that the larger the collateral a borrower can provide, the lower the interest rate will tend to be.[11] In that context, the collateral value is not an exogenous variable to a loan contract, but is internally determined by the level of the interest rate and the security value.

It is important to note here the valuation that a lender assigns to a collateral: to the extent that the lender assigns it a value significantly below that given by the borrower or the market, the interest rate needs to be substantially higher.[12] In such a case, considering that high transaction costs of an asset have a negative effect on the lender's valuation of that asset as collateral, higher collateral transaction costs will be related to higher interest rates.

This explains why in the presence of imperfect information, higher interest rates will be observed for loans in situations where there are problems of using an asset as collateral.

e) Collateral and Loan Duration.

The need for loan information varies according to the duration of the loan payback period. When these periods are longer, there will be a greater likelihood of something happening that will affect the borrower's repayment capacity. Consequently, lenders will demand more information from borrowers when the payback periods of loans are longer.

However, as we saw above, it is expensive for the lender to obtain information. One way of offsetting greater information needs for long-term loans and of minimizing risks, is to demand more valuable collateral.

As a result, investment loans, which are generally long-term loans, require more valuable collateral than short-term loans. This is a serious limitation for small producers who need to capitalize or replace equipment, but have problems in establishing the collateral that is demanded for such long-term credit. This is one of the reasons why both commercial and development bank loan portfolios for small producers are basically short-term.

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[11] See A. Virmani: "The Nature of Credit Markets in Developing Countries: A Framework for Policy Analysis". World Bank Staff Working Papers, No. 534, World Bank; and K. Basu: "The Emergence of Isolation and Interlinkage in Rural Markets" in Oxford Economic Papers. July 1983.

[12] A mathematical analysis of the relationship between the lender's valuation of collateral and interest rates can be found in R. Barro: "The Loan Market. Collateral and Rates of Interest" in Journal of Money and Banking. November 1976, p. 439-456.

3. COLLATERAL IN RURAL LOANS

3.1 Types of Loan Collateral

Collateral that is used in rural loans can be defined according to various criteria. In this study, two definitions are used. One, uses a legal standpoint and the other one considers collateral from the viewpoint of its acceptance by development banks.

From the legal standpoint, collateral is classified as personal or real. The former is connected with the financial solvency of the debtor or of the third party that stands in for him. Theoretically, all the assets of the borrower or the third party guarantors secure a loan. However, solvency bears the risk that before the loan is repaid, the economic situation of the borrower or of his guarantors or endorsers has deteriorated, that makes it impossible to comply with the obligation. In order to avoid this risk so-called real collateral is established, consisting of goods or assets that, independently of the borrower and prevailing over other debts, secure the loan until its repayment; for that reason, they cannot be used for any other purposes during the loan term.

From the point of view of acceptance of loan collateral by development banks, securities can be classified into conventional and non-conventional collateral. The former refers to collateral that normally has been accepted by development banks that lend to the rural sector. This type of collateral consists of both personal and real collateral. The most important types of personal collateral are loan endorsement (surety-backing) and third-party guarantee, while (land) mortgage and pledging of agricultural assets are the most widely used types of real collateral. Other mechanisms such as guarantee funds and agricultural insurance have also been employed.

Non-conventional loan collateral is used basically by informal and semi-formal financial intermediaries (NGOs, Church lending programmes, development projects, etc.). In fact, over the past five years many of these organizations have been formalized and, with them, also the types of collateral they use. The utilization of such collateral enables many institutions, as we shall see later on, and by using specific rules in particular contexts, to provide access to financial services to sectors that traditionally have been excluded from the formal financial system.

Non-conventional collateral can also be personal or real. Non-conventional personal collateral is also known as social collateral, and is based on the utilization of specific rules, incentives and penalties by existing organizations or new ones which have been created to deliver credit. The most important forms of social collateral are: the endorsement by the organization to which the borrower belongs and solidarity groups.

With regard to non-conventional real collateral, there is the pledging of assets that normally are not accepted by formal financial institutions (such as criollo or mongrel livestock, small animals, and household electrical appliances) and so-called solidarity funds.

Mechanisms like the methodology of graduating customers and inter-linked or trade related credit also operate as unconventional collateral. The latter procedure is used widely by informal lenders.

It is difficult to evaluate the application of any one type of collateral by itself, since financial institutions or lending programmes and even some informal lenders, generally do not request a single type of collateral, but grant loans instead on the basis of a range of loan collaterals, that form part of the lenders' used credit technology.

Collateral evaluation, on the other hand, implies assessing the degree of success of the financial institution or of the lender in reaching the target group of borrowers and in recovering their loans. That is to say, a collateral system is successful, when it demonstrates a capacity to cover a major share of loan applicants in the market segments in which the lender operates and, at the same time, to keep up high levels of loan recovery. Even so, it should be kept in mind that loan recovery not only depends on the existence of a good system of collateral. Aspects such as bad management or political pressures to pardon overdue debtors can have a negative impact on loan recovery.

The key features of these types of collateral are described briefly below, and an analysis is given of their respective advantages and disadvantages. Also, and depending on available data, the performance of those experiences are assessed where specified types of collateral have played a crucial role.

3.2 Conventional personal collateral

a) Endorsement (Surety-backing).

Concept:

This type of personal collateral is formalized by the signature of the endorser that is stamped on the back of the loan document or the bond instrument. It is also defined as a collateral given as partial or total payment for the obligation contained in a debt instrument.

Characteristics:

- This is an always binding type of collateral that should be written down in the debt instrument itself or on a sheet attached to it. All that is required is the signature of the endorser on the back of the document. It is identified by the word "endorsement" or its equivalent.

- The responsibility of the endorser is jointly shared with that of the endorsee --that is to say the endorser is bound by the same terms as the endorsee vis-à-vis the credit or bond instrument holder.

- The obligation derived from acting as an endorser is limited to the terms stipulated in the debt document.

- A sum larger than that stated in the debt instrument cannot be demanded from the endorser, nor can the holder go beyond what the document stipulates.

- The amount secured by the endorser will be determined by what the endorsement expressly states, so that if it does not limit its responsibility to a specific amount, it will be understood that it secures the whole amount of the obligation stated in the debt instrument.

Requirements:

In order to formalize this type of collateral, the following is required:

a) The consent of the person who will act as endorser, such to be stated in accordance with established legal formalities.

b) The capacity of the person acting as endorser to legally bind himself.

c) The principal obligation should be stated in a bill of exchange, a promissory note or a cheque.

d) The endorsement has to state the name of the endorsee. When the endorsement of the obligation is contained in a bill of exchange, the failure to comply with this requirement will mean that the endorsement is considered to be granted to secure the acceptor and, if the bill of exchange has not been accepted, to secure the drawer.

e) In some national laws, all persons capable of obligating themselves can act as endorser; in others, all persons can, except for the drawer, endorser or acceptor of the debt instrument; and in still others, only the acceptor of a bill of exchange or the drawer of a promissory note are excepted.

Effects of Endorsement:

- As a result of this type of collateral, the endorser is obligated jointly and severally together with the endorsee, in the same way that the person so secured is obligated versus the debt instrument.

- The endorser who complies with the payment of the obligation, will be entitled to take recovery action against the person so secured as well as his co-debtors.

- The endorser remains validly obligated, even if the person so secured is not.

- The endorser cannot oppose the holder of the debt instrument by using the personal defense of the person so secured.

Endorsement in Rural Loans:

This type of collateral can be constituted fairly easily through the signing of documents in which the borrower or a third party agree to secure the loan; this means low transaction costs for the borrower. It does, however, introduce additional costs for the lender, for if the endorser has no proper credit record or is not an institution of proven creditworthiness, then his capacity to repay the loan will have to be evaluated. Its major drawback, however, is its dependence on the wealth of the endorser during the contract period. Consequently, any economic eventuality that reduces the payment capacity of the endorser will negatively affect the possibility of recovering the loan.

In rural loans, particularly those granted by development banks, the use of surety-backing is not as common as it is in commercial banks. Development finance institutions that have used third-party surety-backing generally have done so as a means to supplement other types of collateral or have demanded that the security be granted by institutions whose solvency is beyond all risks. So it is that in Colombia, third-party surety-backing is accepted as collateral by the Fondo de Financiamiento Agropecuario only when legally recognized financial institutions act as endorser; the Banco Ganadero also accepts third-party guarantees, but only for short-term loans, as its preference is always for real collateral.

In the case of Guatemala, the Banco de Desarrollo Agrícola (BANDESA) only in exceptional occasions accepts the borrower's personal solvency as collateral; the client must have several years of farming experience and an excellent credit record. In Mexico, the BANRURAL System (credit system for the agricultural sector) considers also the acceptance of surety-backing as loan collateral, but always as a supplementary collateral. In Costa Rica, sometimes third-party surety is accepted for small loans; but the guarantors must be always wage-earners who have a certain income level. In Panama, the Banco de Desarrollo Agropecuario includes surety-backing as collateral, but only for small loans.

The relatively scarce use of surety-backing as collateral by development banks can be attributed to the fact that in the rural sector, above all for small farmers, the possible persons who can act as guarantors are themselves producers, who have the same characteristics as the loan applicants. In other words, their income levels are low and uncertain and they do not have a relevant credit record. In this context, surety-backing in its conventional form does not provide a major security to lenders.

b) Third-Party Guarantee.

Concept:

Through a third-party guarantee, the guarantor obligates himself vis-à-vis the lender to comply with a given payment to secure the debt of another party, in case the borrower (principal debtor) fails to repay. In other words, what is involved is an accessory obligation that is attached to a principal obligation, by virtue of which one or more persons answer for another one's debt; they commit themselves with regard to the lender or creditor, to repay in full of in part, in case the principal debtor does not fulfil his obligation.

Characteristics:

- It is an accessory contract that, like all collateral, assumes the existence of a principal obligation, that is different from and independent of that contracted by the guarantor.

- It is a subsidiary contract; that is to say, the guarantor is liable in case of default by the principal debtor.

- It is a contract that should be in writing, otherwise it will lack force.

- It is unilateral because it entails payments for which only the guarantor is responsible.

- It is a cost-free contract; even so, the guarantor can stipulate with the guaranteed person (debtor), a monetary compensation for his service.

- It can be granted without an order and even without giving notice or against the debtor's will.

- The guarantor cannot be made liable for a debt or credit that is larger than the one owed by the principal debtor.

- The guaranteed party can be the principal debtor or another guarantor; the law recognizes the legality of third-party guarantees and sub-guarantees.

- The rights and obligations of the guarantors are transferrable to their heirs.

- The guarantee of the third party, with the exception of the legal and judicial guarantee, cannot be replaced by a mortgage or a pledge without the lender's explicit authorization.

Essential requirements:

The essential requirements of third-party guarantees are considered to be the following:

a) The "consent" that the guarantor and the lender should give; the intervention of the debtor is not necessary and can even be ignored.

b) The existence of a "principal obligation". There can be no guarantee without a principal obligation. It can be an obligation regulated by a civil code or a natural obligation not enforceable by law, pure and simple, or subject to a condition, present or future, of giving, doing or not doing a certain thing.

c) The guarantor shall be a person capable of obligating himself, be solvent and reside in the country.

Effects of Third-Party Guarantees:

a) <u>With relation to the Guarantor and the Lender</u>

- The guarantor may pay the lender in all cases in which the principal debtor cannot do so. The payment will be opportune, if it is effected before the lender makes a claim.

- The guarantor may request the lender to proceed against the principal debtor. If the lender fails to comply with this or delays his action against the debtor, then the guarantor will be freed from any liability for the debtor who becomes insolvent after the date that the lender was required to act.

- If the benefit of division has been stipulated in case of a plurality of guarantors for one and the same debt, then each guarantor can demand, in the event of a claim, that the lender reduces his action to the part corresponding to him.

- The guarantor may not be obligated to pay if the lender has not had first recourse to the borrower's assets. This recourse is not admissible:

a) If the guarantor has explicitly renounced it;

b) If the guarantor has obligated himself jointly and severally with the debtor; and

c) If the debtor goes bankrupt.

- If the lender puts the guarantor in the situation of not being able to have recourse to replacement in the actions against the principal debtor or against other guarantors, then the guarantor will be entitled to a reduction of the claim (made by the lender) of all that was not possible to be obtained from those (the debtors) through legal subrogation (replacement).

- The guarantor may confront the lender with all the debtors' real exceptions, but not with his personal ones.

- If the guarantor pays the lender in order to terminate the obligation without first having received a claim, instead of opposing the lender with real actions that were available to him, then he will lose any action against the debtor who was not warned by the guarantor of the payment to be made. However, the guarantor keeps his right to take action against the debtor.

b) <u>With relation to the Guarantor and the Debtor</u>:

- The guarantor will be entitled to act against the principal debtor to give him relief, to assure him the benefits of the guarantee or to allocate sufficient assets in order to comply with the secured obligation:

a) When the principal debtor squanders or boldly risks his assets;

b) When the principal debtor fails to secure his relief by the agreed upon date;

c) When the principal debt incurred for a certain term or at certain conditions becomes fully or partially payable;

d) If 10 years have elapsed since the guarantee was given, unless the principal obligation was contracted for a longer time period;

e) When there are well-founded reasons to fear that the principal debtor will disappear without leaving behind enough real estate to pay off his obligation;

f) When the principal debtor goes bankrupt or becomes insolvent.

- The guarantor who pays, replaces the lender in all his rights against the debtor and can take action against the debtor for repayment of any money involved.

In legal terms, the difference between surety-backing and third-party guarantees resides primarily in the fact that surety-backing (a commercial law instrument) is constituted through the signing of a debt instrument, while the guarantee (a civil law instrument) is constituted by means of a guarantee contract for compliance with the performance of another party's obligation and it may take the form of either a simple or a joint and several guarantee.

Third-Party Guarantees in Rural Loans

As in the case of surety-backing, these guarantees are rapidly established and involve low transaction costs for the borrower, but not for the lender, who must assess the guarantor's solvency. Also, similarly like surety-backing, this type of collateral has the disadvantage of depending on the guarantor's wealth. However, unlike it, the lender can bring suit against the guarantor only after he has exhausted all other legal means of recovering the sum owed by the borrower.

Third-party guarantees have been used even less than surety-backing. In Honduras, the Banco Nacional de Desarrollo Agrícola (BANADESA) accepts third-party guarantees, but only when it is impossible to constitute a mortgage or a pledge. The legislation of BANRURAL in Mexico also provides for the possibility of establishing guaranties as loan security but, in general, preference is given to mortgage and pledge collateral.

3.3 Conventional Real Collateral

a) Mortgage.

Concept:

Mortgage provides the lender with a real right (right pertaining to real property) over a real estate, that the borrower or debtor has furnished as collateral. The lender keeps this right until the debt is paid off, irrespective of who is the owner at that moment, while the borrower maintains the right to usufruct the mortgaged property. To mortgage real property, it is essential that the property rights are adequately defined.

Characteristics:

- It is an accessory real right that follows the course of the principal obligation it secures and it affects only real estate.

- It is binding. In the case of a conventional mortgage, the contract should be drawn up in a public notarial document.

- It is indivisible. In order to be executed, the collateral cannot be subdivided. Until the principal obligation has been fully fulfilled, the lender maintains his full right on the property on which he has a mortgage lien.

- It is not subject to physical transfer. In other words, the possession of the mortgaged property is not transferred from the debtor to the lender by virtue of the contract, but it remains in the hands of its owner.

- It is a real right that is established with the registration of the encumbrance in the pertinent registry; as a result, the mortgage will become effective on the date of its registration.

- It is a real right that may secure any obligation, whatever its origin, of one's own or of a third party, provided that said origin has been or can be determined.

- It is subject to public disclosure of its official registration, which means that there can be no hidden mortgages.

- It is subject to the principle of specialty. In other words, the contract must be clear and precise in stating the characteristics and location of the real estate on which the lien is established, as well as specify the amount of the obligation so secured, the interest claims and any other matters that can be contracted by the debtor and the lender.

- The mortgage may only be established by the owner of the real estate or the person legally authorized by him for that purpose.

- The mortgage can secure a future or possible obligation and can be constituted as a term mortgage or at certain other conditions.

- A mortgage cannot be constituted on future real estate.

Effects

A mortgage generates rights and obligations between the contracting parties (lender and debtor) and other effects that involve third parties that have not taken part in the contract and that, therefore, are alien to either of the two parties to the principal obligation.

The following effects of a mortgage can be distinguished:

a) With Relation to the Lender.

- He has the right to be paid through the sale of the mortgaged property in the event of the debtor's default.

- He enjoys the right to pursue the mortgaged property. No matter who possesses or holds the mortgaged real property --in the event that the debtor has ceded his possession or transferred his ownership to a third party--, with the default of the obligation, the lender may bring action against the debtor and have the mortgaged property put up for public auction, because those legal acts do not affect the continued existence of the real collateral.

- The mortgagee enjoys the right of preference over third parties in the payment of his loan from the proceeds from the sale of the mortgaged property.

- If the mortgaged property loses its value because of deterioration or by any other cause or if it is lost, then the lender will be entitled to demand that the debtor improves his collateral or constitutes another security with an equivalent value, that guarantees the performance of the obligation. If he fails to do so, the lender can bring legal action for advance payment of that obligation.

- The lender can cede his credit claim to a third party together with the mortgage that secures it and can also cede to a third party the preference order or priority to which he is entitled as mortgagee in favour of other mortgagees.

b) With Relation to the Debtor.

- The owner of the mortgaged property maintains the right to dispose of it.

- He can establish new liens on the mortgaged property.

- When the mortgage value exceeds double the amount of the known or presumed amount of the principal obligation, then the debtor will be entitled to reduce the mortgage.

- He has the obligation to take care of the mortgaged property by avoiding its deterioration and devaluation.

c) <u>With Relation to Third Parties</u>.

- Other creditors are subordinate to the preference order enjoyed by the mortgagee.

Termination of the Mortgage:

The mortgage is terminated: by payment of the principal obligation; by revocation of the right of the person who established it; due to the total destruction of the mortgaged property; by expiry of the period during which the mortgage was established; by the lender's explicit renunciation; by prescription of the obligation secured by the mortgage; through annulment or cancellation of the obligation it secures; and as a result of consolidation.

Use of Mortgage in Rural Loans

Mortgage has the advantage of constituting a clear and transparent collateral for the lender. Normally, when land is mortgaged, it has the attributes of appropriability, salability, existence over time and creating a great sensation of loss to the borrower, especially since land is generally the main and often only means of production of the small rural producer. In these circumstances, when the borrower mortgages his farm land, he normally does everything in his power to repay the loan; in extreme cases, the lender is able to recover his capital and interest charges without incurring overly high costs.

The different laws governing Latin American development banks envisage mortgage as possible collateral for securing a rural loan. Its great drawback, however, is that it is generally not accessible to the small rural producer, because property rights have not been fully defined. In many areas, the producer has the right to use, but not to transfer land; moreover, the process of securing land titles is long and costly.

Furthermore, mortgage generally involve high transaction costs for the borrower. The result of all of this is that mortgage collateral is used mainly for large loan operations that are commensurate with the costs of constituting a mortgage. Farmers, however, and especially smallholders, generally request small loans that do not justify the cost of constituting mortgage. This makes these lending operations impossible.

Moreover, lenders, above all formal lenders, often perceive that the transaction costs of land transfer are very high. It is not unusual, even when property rights are defined, that lenders refrain from accepting land mortgage and, obviously from making the loans, because they fear that land seizure will create serious social problems that make the transfer de facto impossible or raise its costs and/or because there will be no buyers for the mortgaged land. All of this results in substantial differences in the valuation of land put up for mortgage between the lender and the borrower; the former tends to undervalue the mortgage value, which is harmful to borrowers, whose real property capable of being mortgaged catches a lower value.

b) Pledging of Agricultural Assets.

Concept:

A pledge constitutes a real right that the lender acquires over tangible movable assets that belong to the borrower. The pledge can involve transfer of the property or not, when the goods remain in the lender's possession, as in the case of pledging of agricultural assets. This pledge can only be established as security for obligations incurred by the debtor in the normal course of his business related to crop cultivation, livestock raising and agribusiness --in other words, by persons engaged in agricultural activities without necessarily owning the farm plots on which the assets offered as security are located.

The use of an agricultural pledge as collateral requires a contract that clearly specifies the asset that is being pledged, the value of the asset, its location as well as personal information on the borrower.

In view of the difficulties with mortgage as has been explained already before, pledging of agricultural assets has been the most common form of collateral used by development finance institutions in the agricultural sector.

Characteristics

- Pledging of agricultural assets does not involve the physical transfer of the asset, since the debtor retains the possession and use of the asset on behalf of the lender, together with the duties and responsibilities of the depositary. However, if the debtor abandons the assets, then they pass on into the possession of the lender or the depositary designated by him.

- An agricultural asset pledge contract is always unilateral, because the debtor who establishes the pledge is the only party bound by it.

- An agricultural asset pledge contract is binding in all cases and needs to be made in writing and be registered in the pertinent Public Registry.

- Am agricultural asset pledge is special, in the sense that the norms require that a full description of the pledged assets be included in the contract that establishes the lien as well as in the public registration in order to permit an easy identification of the pledged assets.

- The following items may be encumbered through the constitution of a pledge:

a) Seeds and fruits of any kind, already harvested or still to be harvested, in either a natural or in a processed state;

b) Animals of any type and animal products;

c) Farm machinery, tools and implements of any kind;

d) Standing timber or lumber; and

e) Sown land or plantations at any stage of growth.

- The pledge applies also to the compensation from insurance that may have been taken on the pledged assets and any other type of compensation for damage to or loss of the pledged assets for which third parties are responsible.

- Agricultural pledges secure with special privilege the capital, the interest charges and other expenses owed by the debtor who established the lien.

Effects

a) <u>With Relation to the Debtor.</u>

- The debtor has the right to keep the pledged good in his possession on behalf of the lender and he can make normal use of the asset. He may lose this right to the lender, if he abandons the asset.

- He has the right to transfer the pledged asset totally or partially, on condition that with the proceeds of the sale he pays off the total liability; if not he will be penalized by invalidation of the transfer.

- He has the right to move the pledged assets away from the site where they were contractually located after having secured first the lender's authorization. If the pledged assets are exposed to a risk which demand their transfer and the lender opposes that move, then the debtor can have recourse to the Judge and may request the transfer of the asset.

- He may free the assets from the lien established on them by paying the obligation (capital, interest charges, and expenses) in advance.

- He shall assume the duties and responsibilities of the depositary in taking good care of the pledged assets.

- He is responsible for paying all the harvesting, conservation and management expenses of the pledged property.

- He can not sign other contracts pledging the same assets without the lender's consent, on penalty of having the transaction be invalidated and the pledged property be sold at auction.

- If he abandons the pledged asset or disposes of it as if he did not acknowledge the existence of a lien or if he pledges the property of others by presenting it as his own, without prejudice to his civil liability, he may be subject to punishment for criminal behaviour.

b) <u>With Relation to the Lender</u>

- The lender has the right to judicially demand the sale of a pledged asset in the following cases:

a) In case of failure of the debtor to comply with the obligation;

b) If the debtor sells the pledged asset and defaults on payment of the loan; and

c) If the debtor removes the asset from the farm without the lender's consent.

- He has the preferential right to be paid from the proceeds of the pledged property before other creditors.

- He shall have the preferential right to acquire the pledged asset if the debtor wishes to sell it in case the sale price is lower than the amount of the debt.

- He has the right to inspect the pledged asset at all times.

- He has the right to collect the pledged asset, if the debtor abandons it, thus causing damage and losses to the lender.

Termination:

The pledging terminates by:

a) Expiration of the obligation it secures;

b) Annulment, cancellation or revocation of the debt obligation;

c) Disclaim by the lender;

d) Total destruction of the asset;

e) Expropriation;

f) Consolidation;

g) Merging of the status of the lender and the owner of the pledged asset.

h) Misuse of the pledged asset by the lender; and

i) When the person who establishes the pledge loses his ownership right on the asset by virtue of a resolutory condition, in which case the lender will be entitled to demand another pledge and the fulfillment of the obligation in advance.

Use of Agricultural Pledges in Rural Loans.

The main advantage of agricultural pledges is that almost all rural producers own some asset or crop they can offer as security. Furthermore, almost all assets that can be pledged are salable.

Given the difficulties in establishing mortgage collateral, Latin American development banks have placed great emphasis on agricultural pledges as a favored security for rural loans, particularly for small farmers. Nonetheless, experience with the use of collateral has revealed problems of appropriability and sustainability. In the first case, the transaction costs related to effectuating the appropriation of the pledged assets are very high, above all, as compared to the relatively small loan sums and in case the borrowers live in geographic locations which have a difficult accessibility. This means that few pledges are executed, thereby exerting a negative impact on the sense of loss. Sustainability is also uncertain, for the pledged assets are subject to multiple risks due to climate, theft, fraud or deterioration, above all in the case of crops and livestock.

Obtaining finance against stocks of a wide range of products held in bonded warehouses is widely used in Latin America and other more developed countries. In the case of food crops, banks may grant inventory credit to traders against the presentation of warehouse receipts. This bank credit provides traders with working capital to purchase more crops from farmers at harvesting time. In general, however, this system is only accessible to traders, larger farmers or well organized groups of farmers.[13]

c) Guarantee Funds

Concept:

These are funds set up by borrowers or third parties (State, NGOs, Church) with the purpose of reducing or eliminating the lenders' portfolio risks and replacing or supplementing the demand for other real collateral. Guarantee funds in many countries are institutions with their own legal status, that have been established by the State and they operate externally to the financial institutions that grant loans to rural producers.

It is only recently that guarantee funds have begun to be used as collateral for obtaining rural loans, mainly by development banks, as an alternative or as a supplement to the use of mortgage or pledging of agricultural assets.[14] However, some private banks have been using also this mechanism recently to secure small rural loans or loans to urban microenterprises.

Guarantee funds operate like supplementary real collateral and they have the advantage of appropriability, since they give lenders access to liquid cash to cover the risk of loan default.

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[13] Inventory Credit: An Approach to Developing Agricultural Markets, in FAO Agricultural Services Bulletin 120, Rome 1995.

[14] There are those who classify Guarantee Funds as non-conventional collateral because of the short time they have been in use. However, since they have been accepted by many development banks and in an increasing number by commercial banks, they better be classified as conventional collateral.

However, when the guarantee funds are created exclusively by the State or third parties, then there is a danger that the producers perceive the coverage of their loan defaults from those funds as automatic and at no personal consequence to themselves. If this occurs, the funds operate as security only to a limited extent, namely for two reasons: in the first place, they are not highly valued by the borrowers and for that reason they do not encourage a compliance with their debt obligation because the execution of the security is not perceived as a personal loss; secondly, by depending on state policies and resources, the continued operation of the guarantee fund is not ensured over time. As a result, it appears favorable to secure the contributions of financial resources to the guarantee fund by small and microproducers themselves, so that these situations do not arise.

In any case, the presence of guarantee funds should not relax the incentives to banks of good loan assessment and management. An effort should be made also to keep the transaction costs of having access to such guarantee fund relatively low, so that it is able to cover small producers.

When the funds are created by the borrowers themselves, then they fulfill almost all of the ideal requisites of collateral, provided no unfavourable economic events like hyperinflation exist, that erode the value of such funds. Generally, however, the sums that small rural producers are able to accumulate as own guarantee funds are small and do not cover a significant proportion of the loans. One way to alleviate this disadvantage is by combining guarantee funds with solidarity group liability, whereby the funds are contributed by all the borrowers/members of the group.

In short, guarantee funds are an important alternative or supplement to conventional collateral. This is a collateral modality that transcends the rigidity imposed by real security, primarily land mortgage, which in most cases is beyond the possibilities of small rural producers.

Use of Guarantee Funds in Rural Loans:

In several Latin American countries guarantee funds have been constituted in order to be able to provide loans to small producers. Among the most outstanding experiences are those of Colombia, Brazil, Mexico and El Salvador. Colombia's FONDO AGROPECUARIO DE GARANTIAS - FAG was created in 1985 and uses government resources to back loans granted through the National Agricultural Credit System to agricultural producers who are unable to offer the security normally demanded by financial institutions. The Brazilian PROAGRO fund was set up in 1991 as a government policy instrument in order to counter defaults by small producers due to natural disasters, blights or diseases affecting farmers' assets.

In Mexico, through the BANRURAL system set up by the State, 32 guarantee funds have been established, of which 29 have a regional scope and 3 are nationwide. In El Salvador, the state in 1992 established the FONDO DE GARANTIA PARA PEQUEÑOS EMPRESARIOS in order to provide them with supplementary collateral, so that they can obtain better access to loans. Venezuela has been implementing a Guarantee Fund as a pilot project since 1995. All of these funds take over the obligation of loan repayment in the case of defaults and from that point assume responsibility for collecting the debts from the delinquent borrowers.

Full information on the performance of these guarantee funds is not available; nonetheless, the available data reveal that many of them are overregulated (the case of Brazil's PROAGRO), have requirements that are not within the means of the small producer (the case of BANRURAL in Mexico) or have little operational and infrastructural capacity in the rural sector (El Salvador's case). Generally, the regulations governing guarantee funds stipulate the possibility of recovering the overdue loans through legal channels. Even so, the fact that governments are the principal source of the resources introduces the possibility of political interference and debt forgiveness.

d) Agricultural Insurance.

Concept:

Agricultural insurance is not a collateral in itself, since the beneficiary of a catastrophe is the farmer and not the financial institution. Even so, in several of their financing schemes, development banks are using insurance against various types of catastrophes as a requirement for granting of small farm loans. This type of mechanism, as in the previous case, seeks to supplement or replace the demand for real collateral by banks from the side of the rural producers.

There are several types of insurance. Among these is the insurance of assets that are exposed to major risk. In this way it can be offered as loan collateral by insuring the permanence of the insured assets during the loan contract period. There exists also crop insurance schemes against specified types of catastrophes.

Insurance mechanisms, however, have problems of viability, since rural activities bear high risks. Because of their high costs, it is not very likely that small farmers will be willing to incur these costs. This can well mean that the conditions of sustainability and permanence in the time will not be met. Moreover, if the producer himself does not pay the full cost of the insurance, or part of it, he will not value properly the insurance protection.[15]

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[15] Strategies for Crop Insurance Planning, in FAO Agricultural Services Bulletin 86, Rome, 1991.

Use of Agricultural Insurance in Rural Loans:

In Latin America, the experiences of the Dominican Republic and Uruguay can be mentioned. In the former case, there is an insurance mechanism that operates as a private legal person under the name of ADACA, in which company 87% of the shares are government-owned. In Uruguay, the Banco de Seguros del Estado offers rural producers agricultural insurance coverage through insurance contracts signed between the Bank and the insured clients, that cover cyclones, drought, earthquakes, floods, fires and other catastrophes.

3.4 Non-conventional Personal Collateral

a) Solidarity Groups

Concept:

This is a security offered by the members of a pre-established group of borrowers, through which each and all members bind themselves to comply with the unpaid obligations of any one of the group.

This form of social collateral, by its very nature, lacks the requisites of appropriability and salability. However, it has been widely used, because it offers several advantages with regard to the other attributes. In the first place, the possibility of repayment is multiplied by the number of the group members, because the entire group guaranties the payment jointly and severally: if one defaults, another, or the whole group of members without distinction, have to pay. Furthermore, as in many cases, the solidarity group with a joint and several liability offers its members the only possibility of obtaining loans on reasonable terms; therefore, group membership is highly valued and the threat of ceasing to belong to such a group is considered a great personal loss.

In addition, this mechanism reduces the lender's transaction costs. Lending small sums of money to very poor people, who have no credit history or can offer no other security, is very expensive and risky. Overseeing several loans simultaneously --the so-called "peer monitoring"-- and the group members' joint and several guarantee of loan repayment may reduce the lender's transaction costs and risks.

This type of collateral, however, has also several disadvantages. From the lenders' standpoint, it is not that obvious that the granting of loan through groups with joint and several liability is preferred by lenders, as long as they have the possibility of a choice between individual and group loans. However, transaction costs and risks decline for the lender, because these are transferred to a large extent to the group. It is the group that selects and monitors the behavior of its members and takes on the task of loan collection, that under other circumstances would have corresponded to the lender. In many cases, even when these costs are high, group lending is preferred by poor borrowers because they have no other alternative. But as the loan amounts grow, and other alternatives are found, the preference for individual loans grows more pronounced both on the part of the lender and the borrower.

Furthermore, in relation to the requirement of durability or permanence over time, the solidarity group with joint and several liability has some restrictions: there is no guarantee that the group will stay together over the time and or that there will be no collusion or payment arrears among group members, which can undermine the process of shared liability. In such cases, the arrears rate can be much higher than for individual loans.[16]

Characteristics:

Distinguishing features of solidarity groups are:

- Normally between three to ten microentrepreneurs join to have access to loans and related services, such as training.

- The group members collectively secure the loan repayments, and the access to subsequent loans depends on prompt repayment by all the members of the group. If a group member defaults, the other members must take on his obligation; if that does not happen, no other member of the solidarity group with a joint and several liability will be able to obtain new loans.

- The loans are appropriate to the needs of the borrowers with regard to size, purpose and terms.

- The loans can be granted to the group or individually to each member and, likewise, the obligation for repayment can be assigned to the individual members or to the entire group.

Essential requirements:

In order that groups operate and efficiently fulfill the requirement of joint and several surety, the following conditions must be met:

- The group must be small and its members must have homogenous characteristics, particularly with regard to their loan needs.
- The members must voluntarily accept the commitment of the cited joint and several repayment obligation.
- The members must value their belonging to and membership in the group.
- The lender must transmit an image of strength and permanence, both with regard to granting as recovering of the loans.
- In some cases, it is necessary to combine joint and several guaranties with other collateral mechanisms.
- The loan size must not be very large.

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[16] R. Schmidt and C.-P. Zeitinger Critical Issues in Small and Microbusiness Finance, article presented at the International Donors' Conference in Vienna on September 27-28, 1994.

Effects:

i. For the Debtors:

- There is a risk that a reliable debtor will have to assume the debts of others and thereby loses his access to credit, because he has failed to choose with care the other group members.

ii. For the Lenders:

- If the members do not value their membership in the group sufficiently, then the incentives for default may be larger than the penalties; in that case, the risk multiplies and the arrears rate can be high.

Use of Solidarity Groups in Rural Loans:[17]

Although this kind of collateral was initially used in the urban sector[18], it has been rapidly also adopted in rural loans. In the beginning, some experiences were not very successful. By way of example, in the Dominican Republic, the Fundación de Desarrollo Dominicana, in the early 70s, started a lending programme for groups ranging from 10 to 100 members, some of which already existed and others that were set up by FDD poromotors. After a sponsored start (in 1973 there were nearly 400 groups), the groups disintegrated (by 1978 there were only 23 groups left) and the arrears rate rose.[19] Nonetheless, later experiences that have rectified the defects noted above, have had great success with credit programmes for the rural poor. At the global level, the experience of the Grameen Bank of Bangladesh, which started out as a pilot project in 1979 and became a bank in 1983, is illustrative.
In Bolivia also, solidarity groups with joint and several liability have been used quite successfully by the Fundación PRODEM and Banco Sol. In Peru, there are three relatively new experiences: in the highlands, the Instituto de Fomento a la Comercialización Campesina (IFOCC) in Cusco and the FONDECAP in Arequipa, and on the coast, the Centro Peruano de Estudios Sociales (CEPES) in Lima's Huaral valley.

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[17] The information on these experiences has been taken from the following documents: R. Christian, E. Rhyne, R. Vogel, "Maximizing the Outreach of Microenterprise Finance", Mimeo, IMCC, September 1994; J.Yaron, "Successful Rural Finance Institutions, World Bank Discussion Papers No. 150, 1992; María Otero, Elisabeth Rhyne, "The New World of Microenterprise Finance", Shorebank Corporation; and conference notes of Eduardo Bazoberry, Executive Director of PRODEM (Bolivia), made in December 1993

[18] In Latin America the experiences of BANCO SOL in Bolivia and CORPOSOL in Colombia are well known.

[19] See D. Adams and P. Romero "Préstamos a Grupos de Pobres Rurales en la República Dominicana: Una Innovación Detenida", in Crédito Agrícola y Desarrollo Rural: La Nueva Visión, D. Adams, G. Gonzáles-Vega and J.D. Von Pischke, editors. Ohio University State, 1987, San José, Costa Rica.

It is important to emphasize the fact that in these successful experiences, the collateral of solidarity groups with joint and several liability functions primarily for small loans; when the loan size grows, other security is demanded, which is preferably real collateral. The groups can also be used for other purposes, like technical assistance, training, etc., as in the case of the Grameen Bank, or only for financial services, as with the Banco Sol. In any case, these experiences show that it is important to analyze the group's characteristics and its willingness, before trying to use groups as well as a conduit for the provision of non-financial services or for other purposes.

b) The Endorsement by the Organization to Which the Borrowers Belong.

Concept:

This is a collateral offered by a grassroot organization to which the borrowers belong, as a means of providing information on their credit behavior and willingness to pay. The organization can be both an association into which producers are grouped to carry out certain tasks (cooperatives, for example) or communities or ethnic groups to which they belong and in which they carry out their social and economic activities.

As in the previous case, the surety of the organization to which the borrower belongs lacks the attributes of appropriability and salability. Its effectiveness as collateral is based on its valuation and the sensation of loss. For many poor farmers, living in a community gives them a feeling of group identity and of belonging and acts as their social reference space; at the same time, it generates several benefits, from giving members access to public goods such as water for drinking and irrigation, etc., to the possibility of obtaining private assets through collective activities like mutual labor, the purchase or sale of collective goods, etc. This makes that honour and prestige within the community are highly valued.

In granting its endorsement, the organization commits these values --the feeling of belonging to and having access to goods--, and for that reason, community surety is quite valued. Failing to pay means discrediting the community and losing one's own prestige within it. In the worst case, this discrediting can cause the loss of the economic and social reference group, which would be highly damaging.

Other advantages of a grassroot organization's endorsement are that it reduces the transaction costs both for the lender and the borrowers.

Surety can be provided by the organization as a whole, or by an authority representing that organization.

This type of social collateral does not operate in places where there are no strong organizations, that makes successful experiences difficult to replicate. Furthermore, there is always a possibility that disagreements within the organizations will impair their very raison d'etre and that they will not be permanent over time. Collusion can also arise between borrowers and the organization's leaders or authorities.

Characteristics:

- In order to operate efficiently as collateral, it is important for the organization to have been already in existence before the loan operations started and for its members to be aware of and to be able to testify to the loan applicant's credit behavior.

- This collateral generally does not secure the monetary value of the loan --in other words, it is difficult for the organization to recover the loan amount disbursed but not repaid and for that reason, it is always subsidiary to and supplementary to other types of security.

- This collateral works well for borrower selection and loan recovery, but not for the monitoring of loans, in case there is a large number of members in the organization.

- Endorsement by the organization generally supplements other types of collateral and takes advantage of economies of scale in obtaining information on members, that can be obtained from the organization.

Used Endorsement by Grassroot Organizations in Rural Loans.

This collateral has been used successfully in the two already-cited Peruvian experiences, those of IFOCC (Cusco) and FONDECAP (Arequipa). Using endorsement by the organizations, combined with the guarantee of solidarity groups with joint and several liability and real collateral, have led that loans have been extended to almost 5,000 small farm households in the Peruvian highlands. In all these cases, preexisting grassroot organizations like the "comunidades campesinas" (ancient institution of the organization of Andean small farmers), multi-community organizations (gathering of communities) and others, such as mothers' clubs and the board of water users, help to preselect the credit recipients from among their members and provide them with surety; they commit themselves to take proper actions to ensure that the borrowers comply with their contractual obligations.

This organizational surety is supplementary to other types of non-conventional real and personal collateral. All these organizations secure individual loans that use real guarantees; however, since these last ones are insufficient in monetary terms and difficult to execute, the lending institutions use the borrowers' organizations together with other types of collateral.

3.5 Non-conventional Real Collateral

a) Non-Conventional Pledges

Concept:

Non-conventional pledges do not vary in definition or attributes from agricultural pledges. The difference lies in the type of asset that is pledged. In this case, rural borrowers pledge criollo or mongrel livestock or smaller animals (pigs) and household electrical appliances, that normally are not accepted as pledges by commercial banks or development finance institutions.

This collateral type was first used for loans to urban microentrepreneurs and normally has taken the form of pawnshops, where jewelry is pawned or pledged for loans and where the pledge remains in the lender's possession. The system then evolved into one where the pledge remains in possession of the borrower. In view of their success, these collateral systems have been adopted by several credit programmes that operate in the rural sector.

The non-conventional pledges have the advantage that most rural producers possess goods that can be used to establish this type of collateral. Furthermore, it does not involve large transaction costs for the borrower, because the pledges do not have to be registered; all that is needed is an ownership document or declaration and a contract, which transfers the pledge to the lender. Obviously, these goods also represent a sensation of loss for the producers. They do have, however, an advantage over the pledging of agricultural property, since they involve assets that already exist at the moment of signing the loan contract. Nonetheless, they share several of the drawbacks of conventional pledges, in the sense that the assets can loose value, by loss or theft; also, the seizure of this collateral generally involves high transaction costs in the rural sector.

The Use of Non-conventional Pledges in Rural Loans.

Non-conventional pledges have been used successfully as collateral for loans to small producers in several credit programmes carried out by some specialized banks and NGOs. Among banks that use non-conventional pledge as collateral is the Rakyat Bank of Indonesia. All that this institution requires as a guarantee for small loans is the presentation and deposit (in the bank) of a document accrediting the ownership of an asset. In this case, the execution is costly and often difficult to carry out through legal channels, but the security offered represents an important commitment of the borrower.

Among the NGOs using this mechanism is the Peruvian IFOCC. This agency grants loans to farmers organized into solidarity groups with joint and several liability. One of the types of collateral required is the pledge of cattle; the livestock, however, is frequently of poor quality and judicial execution of the pledge involves relatively high transaction costs. In practice, execution is carried out very rarely, but an important aspect lies in the perception of farmers that the pledge can be executed in the event of non-compliance with the loan obligation.

b) Common Group Funds

Concept:

Common funds are a type of collateral that combines the mechanism of solidarity groups with that of guarantee funds. Each one of the members of the group with joint and several liability pays resources (generally money) into a common fund that serves as collateral for loans granted to the group members. This fund is deposited into an account that is made available to the lender so long as the loan contracts is in force and may only be used to cover unpaid loans. This account usually earns the normal interest rate that is paid on savings accounts.

The common fund may be shared among the members of a group with a joint and several liability once the loans are repaid, or can be used as a guarantee fund for a future loan. This mechanism assures the lender not only with the social pressure that can be exerted by a solidarity group, but also with real collateral that can be executed rapidly and does not involve large transaction costs.

Common funds fulfill the attributes of appropriability, easy execution and create a sense of loss to the borrowers. Their sustainability is closely related to stable macroeconomic policies. In an environment of high inflation and/or with interest rates fixed below the market prices, the sustainability of the fund will be very shaky. Furthermore, common guarantee funds impose some additional transaction costs for the borrowers, for someone within the solidarity group with joint and several liability must take the responsibility for collecting the funds and group members cannot obtain loans until all the members have made their contributions to the common fund.

There are also operational problems with the administration of common funds when there are no financial intermediaries available that offer savings facilities in which to deposit the funds. Placing the solidarity funds directly in the hands of lenders entails the risk of their illicit appropriation.[20]

Sometimes common funds are constituted through contributions that group members are forced to make in order to obtain loans. In this case, the fund imposes a saving discipline that can serve to promote saving and increase loan resources. Forced savings, however, impose costs on group members, who cannot withdraw their savings to allocate them to other uses and therefore frequently they have to turn to informal moneylenders to obtain resources they need in case of emergencies. Furthermore, the saving process often takes a considerable length of time before loans can be obtained.

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[20] This has a greater probability of occurring when the amount of the solidarity fund surpasses the debt of the members of solidarity groups with joint and several liability.

Use of Common Funds in Rural Loans:

A number of institutions have used common funds for their loans to the rural sector, primarily those intended for small rural producers. Among these can be mentioned the Grameen Bank, which establishes common funds through forced savings. The Bolivian Banco Sol used also this mechanism at its beginning. In Peru, CEPES also utilizes common funds as collateral, but without having recourse to forced savings. Generally, the experience of these institutions with common funds has been positive. It is important to point out, however, that common funds cover only a small portion of the loans; for larger loans, it is generally necessary to supplement these funds with other real collateral.

c) Blocked Savings.

Concept:

Blocked savings are savings that the potential borrower gradually, but continuously, deposits into an account until a certain amount has been accumulated that will serve as collateral for a loan. Once the loan is made, as in the case of the common funds, the savings remain blocked or frozen while earning interest until the loan has been repaid. This surety is usually supplemented by other collateral, inasmuch as the borrower is unable to save large sums.

Blocked savings offer the advantage of constituting real collateral that can be rapidly executed without transaction costs for the lender. They also promote savings and, through this, contribute to increase the volume of loanable funds. The very process of saving gives the lender also information about the borrower, thereby reducing the problems of imperfect information.

Even so, as in the case of common funds, this mechanism entails relatively large transaction costs for a borrower who intends to obtain a loan through forced savings; he must generally wait a relatively long period of time before he has accumulated enough savings to obtain the loan. Again, when there are no financial institutions where to deposit the savings, then it can be risky to trust the lender with those savings.

Use of Blocked Savings in Rural Loans:

One of the most important experiences with blocked savings is the one of the Fundación Integral Campesina (FINCA) in Costa Rica and other Central American countries. Groups of borrowers, generally women, are formed and elect a board; the borrowers periodically pay in a given sum of money, which serves as collateral and at the same time enlarges the volume of loanable funds that initially come from FINCA. Sometimes, after several years, the amount of savings paid in surpass the external FINCA funds.

This mechanism appears to function well when the loans and amounts saved are relatively small, because the payments can be assumed without problem by the borrowers-savers. However, when larger loans are needed, then the savings quotas also have to increase or the saving periods have to be extended.

3.6 Other Non-Conventional Collateral

a) Graduation

Concept:

Under this system, the lender allocates a small amount of money in the form of a loan to producers who are first-time credit applicants. Once the borrower makes all his payments at the stipulated times, he is automatically promoted to a higher category, entitling him to a larger loan. This system is applied only up to a certain loan limit. Institutions also take care to ensure that the volume of loans that use this mechanism does not put at risk the performance of the overall loan portfolio.

Although some people do not consider graduation as a security in itself, it is a system that generates some of the conditions that characterize loan collateral. In particular, graduation is based on the valuation given by the borrower to the loans he receives and on his perception that the lender is going to increase the credit line as agreed and that the lender is going to remain in business over time. As a result, losing access to the credit entails a great sense of loss.

The major advantage of graduation is that it allows small producers to have access to loans, while the borrower or lender does not incur high transaction costs. If the financial institution manages to increase the volume of its loanable resources from savings or other sources, then this enables it to continue expanding its portfolio, for, in practice, the institution has a captive clientele.

This system obliges the lender to transmit to the borrowers a perception that he will remain in business and that he will increase his future lending. Normally, these conditions are difficult to visualize for the lender, especially if the institution is relatively new. Another disadvantage is that the system calls for increasing amounts of loanable funds, as debtors may consider themselves entitled to growing loans and may feel disheartened or betrayed if the loans committed are not forthcoming. Furthermore, it is very risky for the lender to base his entire portfolio on this system; this is the reason why graduation is usually used as a supplement to other types of collateral.

Use of Graduation in Rural Loans:

This system is applied in almost all the experiences that use non-conventional loan collateral. The BRI, the Grameen Bank, Banco Sol, IFOCC, and FONDECAP, among other institutions, use graduation very effectively, because it enables these financial institutions to gradually know the borrowing capacity of their clients; these, in turn, progressively build up trust in the institution. The system has also been used by some development banks. The Banco Agrario del Perú, for example, rated its borrowers with a satisfactory credit record as "Class A" clients, to whom loans were granted through the mere signing of a promissory note.

b) Interlinked or Trade Related Credit

Concept:

Although this collateral system is not used by formal lenders or NGOs that grant loans, it is widely employed by informal lenders. A loan is granted, conditional on another kind of transaction that the lender also effectuates with the borrower. The terms of both the loan and the transactions (such as sharecropping and agricultural input and output marketing arrangements) are set at the same time. Faced by a loan default, the lender will take action in particular with regard to future loans and interlinked transactions. For that reason, it is also called a "tied loan". For example, a trader makes a loan to a farmer, with the commitment of the latter to sell to the trader at harvesting time his crop; if the farmer defaults, the trader will not give him a new loan and will also retaliate in the marketing of his crop (by not buying it from him or discrediting the farmer with other traders).

An interlinked or trade related credit transaction works, if the borrower views his relationship with the lender, both in terms of the loan and the other transaction, as valuable and permanent.

Use of Interlinked or Trade Related Credit in Rural Loans:

Not many development banks or NGOs and other semi-formal financial institutions have used interlinked or trade related credit directly. Undertaking other non-financial activities and linking them to credit increases also the risks to the institution, since in addition to the risks inherent to lending, the institution would have to assume the risks of the other activities such as trading. Moreover, the execution of different types of activities creates problems in attaining the specialization needed for managing effectively financial intermediation services.

Nonetheless, there are some experiences of development lending programmes that have lent to informal moneylenders who use the interlinked or trade related credit system. In this way, financial institutions have been able to increase their lending to small farmers and thereby to enlarge their coverage by working through these informal lenders. A pilot experience of this kind was that of the National Agricultural Productivity Programme in the Philippines and the evaluation of this experience shows that although loan recovery was quite good, the farm loan coverage did not grow and the lending terms to farmers did not improve significantly, as informal lenders generally replaced their own funds with those they obtained from the government loans.[21]

[21] See E. Esguerra "On the Use of Informal Lenders as Conduits for Formal Credit: The Case of the National Agricultural Productivity Programmes in the Philippines: in Economic and Sociology Occasional Papers, No. 1351. May 1987. Ohio State University.

Recent investigations suggest that the effectiveness of using this type of mechanism is related directly to the market structure in which the informal lenders operate.[22] In the presence of collusion or monopolistic market conditions, programmes that aim at increasing formal lending will provide no major benefits to the rural borrowers. But if the market structure approaches or is similar to that of a competitive market, then the programmes may benefit the final borrowers.

[22] See M. Floro and D. Ray "Direct and Indirect Linkages between Formal and Informal Financial Institutions: An Analytical Approach". Mimeo, 1995; K. Hoff and J. Stiglitz "Moneylenders and Bankers: Price Increasing Subsidies in a Monopolistically Competitive Market", Mimeo, September 1995.

4. CONCLUSIONS

1. Collateral is essential to lending and has both legal and economic aspects. Legally, collateral provides an instrument for exerting coercive claims in the event of loan default. The termination of the obligation or debt legally entails the termination of the collateral. Economically, in the presence of imperfect information, collateral facilitates client selection, encourages borrowers to take actions that are conducive to loan repayment, and is a coercive element that reduces the probability of loan default.

2. Not just any asset can be used as collateral. Economically, in ideal terms, collateral should fulfill the attributes of appropriability, salability or marketability, involve a sense or value of loss to the borrower, be durable or sustainable during the contract period and entail transaction costs that bear relation to the borrower's income and the loan amount. As a result, an asset's collateral value is not absolute, but depends on the economic and social context in which the loan contracts are situated.

3. In legal terms, collateral can be classified as: personal collateral and real collateral. The former depend on the wealth of the borrower or his guarantors. It therefore entails the risk that a decline in that wealth will make it impossible to cancel the loan. Real collateral commits specific assets that secure the debt until it has been paid off.

4. Collateral can also be distinguished into conventional and non-conventional collateral in accordance with its acceptance as security by formal and semi-formal or informal financial institutions.

5. Personal collateral is generally not used by development finance institutions. The reason for this is that rural producers usually have no credit history and their wealth is subject to greater risks than that of other types of producers. Furthermore, possible guarantors are also small producers, who share the same characteristics as the rural loan applicants.

6. Among conventional collateral, real assets and in particular mortgage are the closest in fulfilling the ideal economic attributes of security. Mortgage, however, is a mechanism that is not accessible to most small rural producers, since there are problems in defining their land property rights and their land is frequently not very productive. The transaction cost of mortgage foreclosure is normally also very high.

7. Pledging of agricultural or livestock assets is a type of conventional collateral that is mostly used in rural loans. However, it entails problems of appropriability for the lender, above all when the borrowers are small producers, because it is extremely expensive to execute the security in the case of loan default. As a result, commercial banks are reluctant to accept this collateral from small producers.

8. Guarantee funds that are contributed entirely by third parties and agricultural insurance without cost or with subsidized premiums present problems, since they do not entail a sense of loss to the borrower and have a negative impact on the performance of financial institutions. In those cases, they may secure the loans of creditors or lenders, but they do not provide borrowers with major incentives to embark upon actions for repaying the loans, nor do they entail an adequate coercive element.

Furthermore, they do not encourage financial institutions to effectuate an efficient loan management, since recovery of the loans appears assured. Frequently, the continuation of these types of collateral is not sure, because it depends on the government policy and/or the donors who contribute to the fund or to the insurance scheme.

These collateral systems increase also the transaction costs for borrowers, who find themselves forced to comply with a series of requirements in order to obtain the guarantee; they also entail costs for the government, insofar as the collateral itself is concerned, as well as in keeping up a state bureaucracy. There are, however, also some experiences in the region where the procedures have been streamlined and where transaction costs have been reduced.

9. An effort should be made to solve the cited problems in the use of guarantee funds and insurance. It is important for borrowers to sense a real loss in the event of default and their contributions to the constitution of a guarantee fund or the payment of insurance premiums can attain this. However, guarantee funds contributed by the borrowers are able to cover only a small portion of the loan amount, and must therefore be supplemented by other types of collateral.

   It is even more difficult to monitor banks or financial institutions in order to ensure their successful performance. Some elements that could be considered are: covering only a certain percentage of the unpaid loans --a portion that is considered acceptable--, or collecting higher premiums in case of loan defaults. In any case, over-regulation and a large number of requirements for guarantee fund and insurance schemes should be avoided and above all, debt forgiveness should be completely banished.

10. Personal collateral is mostly used as non-conventional collateral, particularly the joint and several guarantee of solidarity groups and the endorsement or surety of the organization to which the borrower belongs. Graduation of borrowers is also commonly used to encourage loan repayment.

11. Non-conventional personal collateral --the surety or endorsement of the organization to which the borrower belongs and joint and several guaranties-- and other types of non-conventional collateral such as progressive graduation and interlinked or trade related credit essentially affect the sensation of loss experienced by the borrower and have an impact on transaction costs. The former two are based on the loss of social value within relatively small geographic spaces, that can result in very tangible economic losses. Progressive graduation and interlinked or trade related credit, on the other hand, are based on the threatened loss of future loans. The advantage of these guaranties is that it enables lenders to reach small producers who possess few material goods or funds that they are able to offer as collateral. Even so, they have the disadvantage that they require a commitment of social coercion to the financial institution and/or transmit the perception that the loan programmes are permanent, especially in the case of graduation.

12. The adoption and inclusion of some of these types of collateral by development finance institutions in their loan systems may be promoted. One way of incorporating the endorsement of organizations to which communal borrowers belong is by including some of the organization leaders as loan officers. In these cases a system of appropriate incentives must be developed to minimize any possible problem of collusion between these

officers and the borrowers. The BRI in Indonesia for instance has a positive experience in incorporating rural community leaders in the bank's organizational structure.

Development finance institutions can also work with solidarity groups with joint and several liability in their lending operations, but they must take care that the groups are small and self-chosen and attention should be given to develop the system properly. In that context, it is advisable to include personnel familiar with this mechanism among the loan officers or to train some of these officers in the system. The Fondo de Crédito Agropecuario of Venezuela has recently incorporated solidarity groups with joint and several liability in its lending schemes and apparently with success.

Graduation is a system that can be adopted easily by any formal financial institution. Even so, the availability of loanable funds must be assured to comply with clients who repay their loans promptly and apply for new loans.

13. Interlinked or trade related credit is a type of non-conventional collateral that is widely used by informal lenders who take advantage of the value of other transactions in particular trade, that they effectuate with the borrower in order to select, monitor and, above all, to exert coercion. This type of collateral has not been commonly adopted by formal institutions or NGOs that operate loan programmes, as it adds further costs and risks to the financial institutions. However, several investigations are currently examining how formal financial institutions, primarily development banks, can utilize these mechanisms.

    The findings of this research suggest, thus far, that knowledge about the structure of the market in which informal lenders operate, is very important in order to define the ways in which development banks can link with these lenders. If there exists competition among informal lenders, then supporting them financially may indirectly benefit small rural producers, but if a monopoly or collusion exists, then the benefit will be uncertain.

14. Experiences with the use of non-conventional collateral in rural loans demonstrate that generally a single type of collateral is not enough, and that often conventional collateral is used as well. In general terms, collateral for small loans may be non-conventional, but when the loan size increases, both non-conventional and conventional types of collateral are used simultaneously.

    Accordingly, one can say that non-conventional collateral replaces conventional security when the loans are small, but is used as supplementary collateral when the loans become larger. These considerations should be borne in mind by development finance institutions that adopt non-conventional types of collateral.

15. It is important to start actions that will make conventional collateral more accessible and less costly for small rural producers. Innovative programmes of defining clear land titles and registering cattle, machinery and household electrical appliances may help significantly to enlarge the number of types of conventional collateral in use.

16. Systems that secure and reduce the transaction costs of appropriate conventional collateral must be improved also. In this context, apart from upgrading the coverage and effectiveness of existing legal systems, one can incorporate also forms of social pressure such as grassroot organizations in order to secure the eventual execution of the collateral.

ANNEX 1

INTERNATIONAL EXPERIENCES WITH NON-CONVENTIONAL COLLATERAL

1. Asian Experiences

a) Rakyat Bank in Indonesia

General Data:

The Rakyat Bank in Indonesia, a state-owned agricultural development bank, was founded in 1972. In 1984, it underwent a radical reform and was given an administrative structure similar to that of a commercial bank; subsidies were abolished and the bank concentrated on small rural producers as its main market segment. Moreover, priority was given to rural savings mobilization.

Loan Portfolio Characteristics:

RBI presents the largest and most successful experience with credit for small rural producers. Data for 1994 reveal the existence of more than 1,800,000 borrowers, close to 7 million savers and more than 3,000 branch offices, of which 80% are located in rural areas.

Loan size ranges from US$ 12 to US$ 12,500 and averages around US$ 290, while the average savings account is US$ 85. The average loan term is 3 months, with an annual interest rate of about 32% a year in dollars. The arrears rate is around 5%.

Loan Collateral and Credit Technology:

Several types of collateral are used, some of which vary substantially in accordance with the loan amount. A document attesting to the ownership of an asset, together with the spouse's signature, are required for all loans. It is very difficult to bring legal action for loan recovery based on these documents, but they do serve as a commitment of the borrower. For loans of over US$ 2,500, the borrower's land title must be countersigned by government officials. A social pressure mechanism is also used by involving worthy persons or local authorities as officers in the selection process of borrowers. The graduation system is employed to reward prompt payers and all future credit is cut off for those borrowers who are in default.

b) Grameen Bank

General Data:

This is another and one of the best known examples of massive rural lending. The Grameen Bank operates in Bangladesh and has taken the legal form of a bank in 1983.[23] Some 75% of the bank's ownership is in the hands of the borrowers and 25% is owned by the state. It has about 800 offices located in rural areas in Bangladesh. The Grameen Bank does not offer voluntary savings/deposit facilities, but it does provide other, non-financial, services, such as education and primary health services.

Loan Portfolio Characteristics:

In 1994 it had over 1,500,000 borrowers, of which 94% were women. The average loan size is US$ 80, with US$ 150 as the maximum loan amount. The average loan term is one year and the annualized interest rate in dollars is 16.5%. The arrears rate is only 1.4%.

Loan Collateral and Credit Technology:

The Grameen Bank lends only to self-chosen groups of 5 members each. These groups act as joint and several guarantors by exerting social pressure and they constitute also guarantee funds that are accumulated through forced savings from the group members. As in the previous case, loan compliance is rewarded with graduation, while as a penalty on loan default credit to all group members is cut off.

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[23] The Grameen Bank started as a pilot project in 1979.

2. Latin American Experiences

a) Banco Sol of Bolivia.

General Data:

The Banco Solidario S.A. or Banco Sol started operations in Bolivia in 1992 and it is the first private commercial bank in the world that specifically attends microentrepreneurs. It is a private bank whose shareholders are important Bolivian entrepreneurs, the Calmedow Foundation, Acción Internacional and the PRODEM Foundation. This bank was set up based on the experience of the PRODEM Foundation with lending to urban microentrepreneurs. PRODEM started its credit operations in 1986.

Banco Sol started urban operations in La Paz and then extended its activities to Cochabamba and Santa Cruz. In 1994 it started also lending operations to small rural producers.

Initially, Banco Sol only lent to groups with joint and several liability and forced these groups to save. Presently, Banco Sol has diversified its services and, in addition to lending to groups with joint and several liability, it grants also individual loans for investment and working capital, consumption and health care. In addition to the forced savings taken over from the PRODEM Foundation, Banco Sol has begun to offer voluntary saving facilities, including time deposits.

Loan Portfolio Characteristics:

In 1994 its global portfolio amounted to over 24 million dollars. Its clients numbered more than 46,000, of which more than 95% live in rural areas.

The average loan size was US$ 602 with a minimum volume of US$ 80 and a maximum of US% 5,000.

The annual interest rate is 55% in dollars and the arrears rate is less than 1%.

Loan Collateral and Credit Technology:

As stated above, Banco Sol initially lent only to groups with joint and several liability, and used accumulated forced member savings as collateral. Today it maintains these groups as a way of selecting borrowers, allocating loans and monitoring, but it no longer demands savings in order to have access to loans.

b) Instituto de Fomento a la Comercialización Campesina (IFOCC), Peru.

General Data:

This NGO was established in 1991 with the purpose of promoting and consolidating the capacity of farming communities to manage the marketing of their products and to obtain loans. Its area of intervention includes the provinces of Acomayo, Paruro, Canas, Anta, Urubamba and Cusco in the Department of Cusco.

The Institution's target population are the members of the various farming communities in the project area, individually and collectively. The loans serve essentially for financing livestock processing and marketing activities.

Loan Portfolio Characteristics:

By December 1995, the IFOCC had a portfolio of about half a million dollars, with loans to approximately 800 members of the different communities with the following characteristics:

- Range of loan sizes: Minimum amount of US$ 28 and maximum US$ 1,000, with an average of US$ 500.
- Duration: Between 2 and 12 months, with an average of 6 months.
- Interest Rate: 18% a year in dollars.
- Penalty interest rate: 1% a month is charged, in addition to the normal interest rate in case of loan default.
- Arrears rate: 1.3%.

The borrowers can use the loans as they wish, with the only condition that the amount obtained be employed for income-generating activities. This fits in well with the short-term financial needs of rural producers.

Loan Collateral and Credit Technology:

Loans granted by the IFOCC are of an individual nature and are secured by community endorsement and the guarantee of solidarity groups with joint and several liability. In order to lend to a particular community, the IFOCC promotes loans to the communities and requires the applicants to organize themselves into small self-chosen groups with between 2 to 10 members, who become joint and several guarantors of the total obligations taken on by each group member.

The IFOCC's credit technology utilizes two organizational levels of social collateral: the small farmer community and the solidarity group with joint and several liability. This social guarantee is supplemented by real collateral that ensures the repayment of the loans in final instance.

The graduation methodology is used successfully: The borrower who repays his loan promptly or before it is due, acquires the right to apply for loans that are above US$ 100 or US$ 200.

c) The Fondo de Crédito y Financiamiento para el Desarrollo de la Microempresa y la Producción (FONDECAP), Peru

General Data:

This NGO was created in 1993 with the purpose of developing financial markets, by incorporating potential clients into the market and improving the regional and national economy. Its area of intervention covers the provinces of Chivay and Chuquibamba in the Department of Arequipa and the provinces of Izcuchaca and Chumbivilcas in the Department of Cusco; it is now planning to open agencies in Juliaca and Huancané, in the Department of Puno.

The institution specializes in financial services and only provides advisory services which are linked to microfinance.

Loan Portfolio Characteristics:

In July 1995, the FONDECAP had a portfolio of nearly half a million dollars and close to 800 borrowers. It has three credit lines: Unrestricted use, working capital and investment loans.

The loan amounts range from a minimum of US$ 100 to a maximum of US$ 500 for loans for unrestricted use; between US$ 500 and US$ 2,000 for working capital; and from US$ 2,000 to US$ 10,000 for investment loans. In the case of the first two credit lines, the loan duration and interest rates are similar: from 1 to 5 or 6 months; and the interest rates are 2% and 5% per month in dollars and soles, respectively. The rates of interest for the investment loans are 1.8% and 3.6% per month in dollars and in soles, respectively.

The arrears rate, defined as the next day after the loan is due, amounts to 1%.

Loan Collateral and Credit Technology:

The loan requirements are: constituting a solidarity group with joint and several liability, endorsement of the organization to which the borrower belongs and real collateral.

From FONDECAP, borrowers obtain individual loans channelled through groups with joint and several liability.[24] Each group is made up of 3 to 5 clients. The solidarity groups with joint and several liability belong to grassroot organizations like mothers' clubs, women's federations, water use committees, associations of producers or microentrepreneurs, communities, and so forth, that elect their loan coordinators and appoint persons with prestige and a recognized sense of responsibility.

[24] Apaza A., René: "Sistematización. Tema: El Crédito como Instrumento Financiero de Desarrollo y de Participación: Una Experiencia en Arequipa". PACT - Peru. CAPRODA. Arequipa 1995.

The organizations should exist at least 6 months, be duly constituted and have a proper legal status. Once established, the solidarity groups with joint and several liability are pre-selected by the organization's assembly.

Before the loan disbursement, the lending operations are formalized through the following documents:

- A loan contract that contains, in addition to the terms, the signatures of all the group members as joint and several guarantors. FONDECAP can then demand payment from each and all of the member clients.

- Evidence of a pledge collateral in the form of a purchase and sales contract for livestock, that can be executed upon default.

- The signing of a bill of exchange by the borrower in favor of FONDECAP.

As in the previous case, the graduation system is employed successfully. The initial loans are small and they grow in size in accordance with the client's repayment behavior and as the microentrepreneur gains more experience in loan management.

d) The Centro Peruano de Estudios Sociales (CEPES), Peru.

General Data:

The Centro Peruano de Estudios Sociales (CEPES) is an NGO founded in 1977 and located in Lima, and traditionally devoted itself to promotional work, research and development communications in the rural areas of Peru. In 1992, with the liquidation of the Banco Agrario, CEPES embarked on a new activity of rural finance with the aim of making small farmers the subjects of commercial bank credit.

CEPES started its work in the Huaral Valley, an area with a predominance of small, modern farmers, who are well-integrated into the market, own good farmland and usually have access to irrigation.

Loan Portfolio Characteristics:

In 1992, through a pilot project, CEPES arranged loans from the Banco de Comercio for 19 farmers with an average amount of US$ 2,700. Starting in 1993, CEPES started to work with the Small and Microbusiness Division of the Banco Wiese. Today, it lends to more than 400 farmers in the Huaral Valley with an average loan amount of US$ 4,000.

The loan duration is set in accordance with the crop calendar, but it usually does not exceed one year. Loans are granted only to finance working capital for annual and perennial crops. The average interest rate charged is 20% per year in dollars. The arrears rate is around 7%. CEPES receives a flat fee of 3% of the loan amount for its services, which fee is normally paid for by the borrowers.

Loan Collateral and Credit Technology:

Several types of collateral are used. For loans of less than US$ 5,000, solidarity groups with joint and several liability are accepted. These groups have between 5 to 12 self-chosen members, who contribute to the constitution of a guarantee fund that amounts to 20% of the loan value. The fund can be constituted by the savings of the borrowers themselves or through a bank loan. This guarantee fund is deposited in a term savings account in the bank that grants the loan and is encumbered in the event of loan default.

An additional mortgage collateral is required for loans of above US$ 5,000.

Table 1: Basic Statistical Data of Credit Programmes with Non-Conventional Collateral

Institutions	Grameen Bank	Bank Rakyat of Indonesia	Banco Sol
A. General Data			
1. Year of Constitution	1983	1972 (Reformed in 1984)	1992
2. Type of Institution	Semi-Public (75% Borrowers, 25% State)	Public	Private
3. Services	Financial + non-financial (Training, Health)	Savings + Credit	Savings + Credit (Individual + group credit)
4. Location/Environment	Bangladesh, 800 branches (rural)	Indonesia, more than 3,000 branches (rural)	Bolivia: La Paz, Cochabamba and Santa Cruz (rural)
B. Client Characteristics	Small rural producers (mainly women)	Small rural producers	Microentrepreneurs + small rural producers (95% rural)
C. Loan Portfolio Data (year)	1994	1994	1994
1. No. of Borrowers	1,500,000	1,800,000 (7,000,000 savers)	46,000
- Women	1,410,000	Not available	Not available
- Men	90,000	Not available	Not available
2. Value of Outstanding Loans	Not available	Not available	US$ 24,000,000
3. Size of Loans			
- Maximum	US$ 150	US$ 12,500	US$ 5,000
- Minimum	Not available	US$ 12	US$ 80
- Average	US$ 80	US$ 290	US$ 602
4. Arrears Rate	1.4%	5%	Below 1%
D. Loan Terms			
1. Eligible Borrowers	Solidarity Groups (5 members)	Selected by Local Authorities	Solidarity Groups/Individuals
2. Graduation	Yes	Yes	Yes
3. Loan Supervision	Not available	Not available	Not available
4. Disciplinary actions for Loan Recovery	Suspension of credit to group	Suspension of credit to group	Not available
5. Annual Interest Rate	16.5%	32%	55%
6. Duration	1 year (on average)	3 months (on average)	Not available
E. Collateral			
1. Conventional	Guarantee funds constituted by forced savings of group members	Pledges Mortgage for Loans above US$ 2,500	Not available
2. Non-Conventional	Social Contract	Social Contract	Not available

Table 1: Basic Statistical Data of Credit Programmes with Non-Conventional Collateral (Cont'n)

Institutions	IFOCC	FONDECAP	CEPES
A. General Data			
1. Year of Constitution	1991	1993	1977
2. Type of Institution	NGO	NGO	NGO
3. Services	Credit + Technical Assistance + Training	Credit: Free disposition, Working Capital, Investment Credit	Promotion, Research, Communication As of 1992: Credit (Working Capital)
4. Location/Environment	Peru, Cusco (55 communities in Provinces of Acomayo, Anta, Canas, Cauchis, Paruro)	Peru, Arequipa (Provinces Chivay + Chuquibamba, Cusco/Izcuchaca + Chumbivilcas)	Peru: Valle de Hural
B. Client Characteristics	Communal producers (Individuals + Groups)	Rural + Urban Microentrepreneurs	Modern small farmer integrated in the market
C. Loan Portfolio Data (year)	1995	1995	1995
1. No. of Borrowers	800	900	More than 400 farmers
- Women	N.a.	N.a	N.a.
- Men	N.a.	N.a	N.a.
2. Value of Outstanding Loans	US% 500,000	N.a	N.a.
3. Size of Loans		Free Use / Working Capital / Investment Capital	
- Maximum	US$ 1,000	US$ 500 / US$ 2,000 / US$ 10,000	N.a.
- Minimum	US$ 28	N.a	N.a.
- Average	US$ 500	US$ 300 / US$ 500 / US$ 2,000	US$ 4,000
4. Arrears Rate	1.3%	1% / 1% / 1%	7%

Continued on next page:

Institutions	IFOCC	FONDECAP	CEPES
D. Loan Terms			
1. Eligible Borrowers	Solidarity Groups (2-10 members) Communal Endorsement + Real Collateral	Solidarity Group (2-5 members) More than 6 months existence, Endorsement + Real Collateral)	Solidarity Groups (2-5 members + Guarantee) Fund + Mortgage (large loans)
2. Graduation	Yes, until loans of US$ 100 or US$ 200	Yes	N.a.
3. Loan Supervision	Group in coordination with IFOCC Staff	Information on Loan Purpose + Amount	Yes
4. Disciplinary actions for Loan Recovery	Additional penalty rate of 1%/month	N.a.	Joint + Several liability
5. Annual Interest Rate	18%	24% (in US$) 24% (US$) 21.6% (US$) 60% (in soles) 60% (soles) 43.2% (Soles)	23%
6. Duration	2-12 months (on average 6 months)	1-5 months 1-6 months N.a.	On average not more than 1 year
E. Collateral			
1. Conventional	Pledges: cattle, crops, electric appliances. No use of mortgage	Pledge collateral + signed Bill of Exchange	Mortgage for loans above US$ 5,000
2. Non-Conventional	Social Contract + Community Endorsement	Community Endorsement + Group Solidarity	Solidarity Fund (20% of loans) for loans of below US$ 5,000