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A WHITE PAPER ON LEGAL OBSTACLES TO SME LOANS IN JORDAN

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JORDAN ECONOMIC DEVELOPMENT PROGRAM (SABEQ)

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EXECUTIVE SUMMARY

The growth of SME financing is most pronounced in emerging markets that benefit from a proper legal framework. Examples include robust economies in Asia and Latin America and in Eastern European countries that transitioned from a command to a market economy following the fall of the Soviet Union. And it matters little if a country was established on civil or common law principles because many differences have been reconciled in the interest of global harmony and economic growth.

This paper identifies two broad legal issues that prevent a meaningful expansion of SME financing, namely, the lack of a Credit Bureau Law and a Secured Transactions Law for Movable Property. The absence of the former law creates grave doubts in the minds of creditors considering SME financing, and absence of the later results in creditors, especially banks, relying excessively on immovable property as collateral for SME loans. This practice limits the JD amounts, the number of SME loans and working capital financing needed to grow SME businesses.

Both legal issues can be remedied if Jordan follows the trend that has evolved in many other emerging markets, i.e. approval of a legal framework for a Credit Bureau and a Secured Transactions (ST) Law for Movable Property. A Credit Bureau Law would allow stakeholders to organize and launch a Credit Bureau similar to the ones operating in the region and in many other markets. A stand alone ST Law is preferable to amending several other related laws simultaneously to achieve the same result. Ease of legislative change is one of the reasons legal experts encourage a stand alone law. Moreover, a ST Law normally creates a Central Pledge Registry that would register and maintain pledge interests (registration forms) in one location, provide effective notice under the law and accelerate settlement among competing claimants to the same collateral.

INTRODUCTION

The writer has spent six of the past twelve months meeting with financial experts¹ in Jordan to identify ways to increase access to SME financing. This paper will present two legal issues that have been identified as obstacles to a meaningful expansion of SME financing:

- Lack of a legal framework for reporting credit history to third parties, and
- Inadequate creditors' rights concerning "movable collateral".²

I will not address related topics such as tax law issues facing the leasing sector. Moreover, the creditors' rights section will address movable property that SMEs are likely to acquire with financing, or already possess, and want to pledge as collateral, i.e. inventory, equipment and accounts receivable.³ Thus, this paper will not address loans secured by ships, aircraft or immovable property and will not focus on trade financing where a creditor controls movable property until settlement by its client. Lastly, the word "creditor" may include credit providers such as banks as well as sellers of movable property that retain title.

¹ Senior bank executives, SME department heads, bank counsel, leasing subsidiaries of banks and officials at the International Finance Corporation.

² Movable collateral is any property that is not immovable property (land and buildings).

³ Bankers say that pledging vehicles such as cars, trucks and busses present less of a problem.

BACKGROUND

CREDIT BUREAU

We need not dwell on the merits of a well conceived credit reporting institution (a Credit Bureau) because the case has been made and the necessity is abundantly clear. The IFC has assisted many countries in emerging markets in forming successful credit bureaus in Asia, Latin America, the Middle East and Eastern Europe. Many success stories have evolved that include considerable growth in financing to SMEs.

The Central Bank of Jordan (CBJ) currently has limited credit information on loans over 30,000 JD. This information is reported and accessed exclusively by banks. Although helpful, stakeholders including the CBJ concede this service does not operate as a Credit Bureau. Clearly, the absence of a Credit Bureau negatively impacts all lending products. However, bankers often say the lack of standard credit history is one of the two main reasons they are unable to expand SME lending.⁴ In addition to stunting SME loan growth, banks can not process loan applications efficiently and in sufficient volumes without a Credit Bureau. In fact, the current situation leads to lending practices considered risky in good times and bad. More background information on this subject is shown in APPENDIX A.

An effort was made in 2003 to create a legal framework for a Credit Bureau⁵ and APPENDIX B provides background on this subject. The sponsoring ministry for a new Credit Bureau Law is now the Ministry of Industry and Trade (MOI). The writer sent a briefing memo and a letter to the Minister's office authorizing SABEQ to retain local counsel to begin work on a legal framework. Briefly stated, SABEQ:

- Received a signed letter from the Minister,
- Retained local counsel to perform limited prep work by researching credit bureau laws in the region (Egypt, UAE, Turkey and Saudi Arabia) and reviewing the 2003 law for adherence to today's best practices,
- Will coordinate this work with the IFC's Credit Bureau Team.

⁴ The other reason often cited is lack of reliable financial information.

⁵ Officially known as the Credit Information Law and Licensing Instructions for the Central Bank, signed by "Abdullah the Second Ibn Al Hussein" as Temporary Law No. (82). 2003

CREDITORS' RIGHTS CONCERNING MOVABLE COLLATERAL

Secured lending against movable collateral is common in developed and emerging markets. Effective legislation exists where legal rights are clearly defined and enforcement over the collateral is predictable following default by the borrower. When these two conditions are not present, confusion follows among lenders, borrowers and members of the judiciary. This is the current situation in Jordan with respect to the use of movable property as collateral.⁶ Clearly, SMEs need this kind of financing for inventory and equipment to grow their business. Thus, SME loan demand will continue to greatly outweigh supply absent legal reform.

Current SME financing practice in Jordan comes down to the amount of immovable property and, to a lesser degree the amount of vehicles, a borrower can pledge. Most SMEs do not own immovable property in sufficient quantity to substitute as collateral for working capital loans. Other than anecdotal evidence, some statistical evidence illustrates the point. In 2006 the Jordan Loan Guarantee Corporation (JLGC) conducted a study on SME financing.⁷ One group was asked to describe the type of collateral pledged to secure loans from their bank. The responses are summarized below:

<i>Type of Collateral</i>	<i>1. Real Estate (Immovable)</i>	<i>2. Vehicle</i>	<i>3. Personal (Guarantee)</i>	<i>4. More than One Type</i>	<i>Total</i>
<i>Number</i>	18	2	8	32	60
<i>%</i>	30%	3%	13%	53%	100%

A former JLGC official confirmed that the response in column 4 (More than One Type) meant two or more types of collateral described in columns 1, 2 and 3. Unfortunately, column 4 responses are not broken down to discern the exact collateral make-up for over 50% of the responses. Column 3 responses represent personal guarantees, which are not considered "collateral" for the purposes of our analysis. Therefore, after removing columns 3 and 4, we see that immovable collateral was used to secure loans 18 times out of 20, or 90% of the time.

⁶ It is possible for capital equipment in factories to be used as collateral but a complicated custodial agreement is required. Normally banks are reluctant to use this procedure unless the collateral is affixed to the building (bolted down) and a reliable custodian is appointed. Also, notary and custodial fees add to the financing costs.

⁷ SMEs Financial Information Study. Jordan Loan Guarantee Corporation's Market Research and Product Department. 2006

Not surprisingly, the Study showed no (zero) bank loans secured by movable property used in the business such as inventory, equipment or accounts receivable. In this regard, the JLG Study is most interesting for what it does not show and verifies the realities of secured lending for SMEs; movable business collateral does not matter, land and buildings matter a great deal.

why do banks place such a high level of reliance on immovable collateral? The two reasons most often cited are:

- The collateral instrument or mortgage is clearly reflected in the land records where the land title is recorded, thereby providing “notice” of a bank’s security interest, and
- Greater control exists by lenders where a mortgage is recorded on immovable collateral should the borrower default and the collateral is sold to repay the loan.

Neither “comfort” factor exists for loans secured by movable property.

A trend has evolved over the past 10 years to enact a stand alone law that clearly defines the rights and responsibilities of a creditor and borrower where movable collateral is involved. This stand alone law is normally referred to as a Secured Transactions (ST) Law for Movable Property. One stand alone law that contains language superior to related articles in existing laws is preferable to amending related articles simultaneously in several laws. It should be stated that ST Laws operate well in common and civil law jurisdictions. In fact, the European Bank for Reconstruction and Development (EBRD) developed a model ST Law for Eastern European and Central Asian countries undergoing transition from a command to a market economy. Moreover, the United Nations Committee on International Trade Law (UNCITRAL) is in the final stages of drafting a model ST Law. Both EBRD and UNCITRAL model laws use legal experts from common law and civil law countries to harmonize wording and practices.

Some of the important policy and commercial factors addressed in a ST Law are:

- Scope of application; effect on existing transactions; effective date
- Consumer protection for individual borrowers

- Definition of “finance” or “financing”:
 - conventional credit, guarantee or letter of credit transaction, or
 - Islamic approved transactions (morabah, musawama, istisnah or modaraba)
- Special status of a “purchase money pledge” and “buyer in good faith”
- Formal requirements to create and register a pledge
- Rights and duties of borrower and creditor
- Effect of pledge on 3rd parties; priority among claimants to the same collateral
- Transfer of pledges over accounts
- Enforcement upon borrower default and liquidation of collateral
- Role of the court
- Creation of a Central Pledge Registry

The Central Pledge Registry⁸ is the institutional backbone of a ST Law because of the interaction of pledge formalities, registration and creditors’ rights.

CENTRAL PLEDGE REGISTRY

The Central Pledge Registry (the Registry) allows the borrower and creditor to register evidence of a written “pledge” or “charge” over movable property serving as collateral for a debt. A ST Law normally designates where a Registry would reside and how it would operate. For example, the law may empower the MOI as repository and regulatory body because:

- The IFC and Government of Jordan have discussed using the MOI to register lessor interests in leased assets under the new Law on Leasing. This registry may be expanded later to capture other types of security interests such as a collateral registration for debt⁹, and

⁸ Sometimes referred to in Civil Law jurisdictions as a Central Charge Registry

⁹ According to the IFC, the Law on Leasing is near final approval and will create a Central Registry for lessor interests over leased assets. The GOJ could expand the use of this Registry to include pledges of movable property between creditors and borrowers

- The MOI would serve as a “one stop shop” for creditors considering loan applications and wish to review collateral registrations and company registrations at the same ministry.

Depending on policy and stakeholder desires, a Registry can accommodate collateral pledge registrations as well as:

- Lessor interests in leased assets
- Seller interests in movable property where a buyer takes possession
- Consignment interests in movable property by a consignor

Typically, the pledge agreement between creditor and borrower is a private undertaking and the formal requirements of such an agreement are stated in the ST Law. A sample pledge agreement taken from the EBRD Model Law is attached as APPENDIX C.

A Registry allows a creditor to register in simple, unambiguous terms its security interests in movable property as of a particular date. Normally, a registration statement is used that contains the name of the borrower and the one pledging collateral (usually the same party), the name of the creditor receiving a collateral interest, the maximum amount of debt involved, and a description of the collateral along with dates and signatures of the parties. The registration statement is critically important as it gives notice to 3rd parties and may serve as evidence on matters covered in the ST Law such as determining priority among multiple claimants to the same collateral. The government body responsible for the Registry will alert the general public on the rules and regulations that will include registration requirements. APPENDIX D has a sample registration form taken from the EBRD Model Law.

Registry regulations usually contain protective wording for borrowers such as procedures for correcting registration statements containing inaccurate information or requirements for creditors to cancel registrations once debt is fully repaid. A thorny policy issue that stakeholders face when writing regulations is who has a right to access registration statements. The classic area of controversy centers on whether a party that is not a current or potential creditor, should have access. This subject stimulated considerable debate within the

UNCITRAL Working Group writing its Model ST Law. One side felt total transparency was appropriate and one side felt only “legitimate” parties should have access to prevent possible abuse such as competitors or other “illegitimate” parties obtaining private information that could be used against borrowers.

CONCLUSIONS

CREDIT BUREAU

The MOI has taken an important first step by providing a “green light” to resurrect the Credit Information Law (Credit Bureau Law) or Temporary Law No. (82). Moreover, the MOI, IFC and USAID/SABEQ working as a team will create momentum for presenting a revised Credit Bureau Law to Parliament by the end of this year. Lastly, the writer has talked to many bankers, leasing executives and microfinance lenders and no one has voiced objection to a Credit Bureau Law.

That said, even the most optimistic reformer will admit that enabling legislation does not happen quickly. We are not certain of the reasons why the 2003 law was not implemented. Moreover, when a revised draft law is ready, the IFC Credit Bureau Team, SABEQ and our counsel will need to carefully brief stakeholders, the Legislative Bureau and members of Parliament. We expect many questions and will rely heavily on the IFC’s experience when more difficult policy issues are raised. Eventually, stakeholders will reach consensus on policy issues, some of which will be woven into the draft law and regulations. Anticipated policy topics and issues are shown below:

<i>Topic</i>	<i>Issues</i>	<i>Resolution</i>
<i>Role of banks</i>	Initial ownership – banks only? Disproportionate sharing of credit information Sharing past credit history without borrower consent	Credit Bureau Law or Regulations
<i>Role of the public sector</i>	Ownership (partial or otherwise) Supervisor Provider/user of credit information	
<i>Licensing requirements</i>	Criteria	
<i>Role of utilities, leasing companies, microfinance institutions, etc.</i>	Ownership (partial or otherwise) Equal access and treatment as banks?	
<i>Management</i>	Board appoints internally or uses outside firm	
<i>Data security</i>	Local or outside contractor	
<i>Credit reporting</i>	Accuracy and due process for corrections	
<i>Financial Health</i>	Initial capital requirements, projections, financial management, fee structure	Start-up - Feasibility Study Ongoing – Financial Management and Governance

CREDITORS' RIGHTS CONCERNING MOVABLE COLLATERAL

As with the absence of a Credit Bureau, the lack of a modern day Secured Transactions Law and Central Registry severely restricts SME financing. A proper legal framework would allow more loans in greater amounts to more SMEs without excessive creditor reliance on immovable collateral. Furthermore, it would provide the “comfort factors” to creditors that are now missing:

- Clear definition of rights and responsibilities of the creditor and borrower; describe how and when collateral is liquidated in the event of default, and
- A rules-based Registry that maintains pledge registrations over movable collateral.

APPENDIX A

CREDIT INFORMATION¹⁰

The Central Bank of Jordan (CBJ) provides information about prospective borrowers to the banks. The process was described as follows:

- Banks are required to report to the CBJ certain information about a borrower for loans over JD 30,000
- CBJ keeps this information in its data base
- When considering loan applications, banks request borrower information from the CBJ and it will respond with information from its data base
- Banks are not required to report loans under JD 30,000

Bankers feel this process is inadequate for SME lending because:

- Banks are not required to report loans under JD 30,000 making CBJ's data base "incomplete"
- A borrower could elect to borrow JD 29,000 from a number of banks and incur substantial debt without his/her information being entered into CBJ's data base
- Banks that are focused on the SME market believe the CBJ's minimum reporting requirement of JD 30,000 should be reduced significantly...

Banks can make informal inquiries with other banks but, though well-intended, these inquiries many times are ignored, or the responses are of little value. Moreover, inquiries on a formal basis may run afoul of current law or regulation.

Jordan is without a Credit Bureau. Thus it lacks one of the key analytical tools for scoring models and for assessing creditworthiness of SME loans. Studies in the US have shown that SME owners that pay their mortgage loans, credit card bills, utility bills and other home-related bills are highly likely to repay their business loans. Consequently, credit scoring

¹⁰ Formation of a SME Loan Department, A Report for Banks in Jordan, Kevin O'Brien: USAID-SABEQ Deliverable, pages 7 – 8. October 2007.

models favorably weight and score SME loan requests when a Credit Bureau report shows timely payment of home-related loans. Unfortunately, the banks in Jordan and potential SME loan applicants must proceed without this kind of service.

APPENDIX B

USAID ASSISTANCE WITH A CREDIT BUREAU

The USAID's Achievement of Market-Friendly Initiatives and Results Program (AMIR) was the predecessor program to SABEQ. Like AMIR before it, the USAID funded SABEQ Program coordinates its activities with counterparts within the Government of Jordan.

USAID funded AMIR's activity relating to a potential credit bureau for Jordan and sent local officials abroad to observe similar operations. Other technical assistance included legal work for the Credit Information Law (otherwise known as the Credit Bureau Law) and related Licensing Instructions for the Central Bank. This law was signed by "Abdullah the Second Ibn Al Hussein" as Temporary Law No. (82) in 2003. The Parliament was not in session at the time and later rejected the law on the basis that it was not used during the three years when it was a temporary law. Apparently, this contradicted the "urgency factor" required to issue a temporary law. As a consequence, the law is not legally binding today.

The Financial Services Component of the USAID Jordan Economic Development Program (SABEQ) has as a major objective expanding financing for small to medium size enterprises (SMEs) and has concluded that a Credit Bureau using best international practices under Jordanian law would greatly benefit SMEs. This subject was discussed extensively with the Association of Banks in Jordan, numerous Jordanian banks and leasing companies, USAID and the International Finance Corporation (IFC). Recently, the MOI and IFC requested SABEQ's support in developing a suitable legal framework for a Credit Bureau. This would include a review by SABEQ's local counsel of the 2003 Temporary Law and participation in the drafting of a new comprehensive Credit Bureau Law to be submitted to the Parliament.

APPENDIX C

SAMPLE CHARGING OR PLEDGE INSTRUMENT

{taken from Article 7.5 of EBRD Model Law for Secured Transactions}

1. Name of charger (or pledgor) – the one pledging collateral for a debt

Address of charger/pledgor

{Other identification of charger/pledgor as necessary}

Agrees to grant to

Name of chargeholder (or pledgee) – the one receiving security for a debt

Address of chargeholder/pledgee

{Other identification of chargeholder/pledgee as necessary}

A charge/pledge of the things and rights described below to secure the debt described below.

2. The debt secured by the charge/pledge is {describe the secured debt}.

For a possessory charge/pledge, state maximum amount of secured debt.

3. Include identification of person owing the secured debt if not charger/pledgor named above.

4. The collateral charged/pledged are {describe charged/pledged property}.

5. Other matters pursuant to Article 7.5 of the Model Law (formalities of a charge/pledge).

Signature of charger/pledgor and date of signature

Signature of chargeholder/pledgee and date of signature

APPENDIX D

SAMPLE REGISTRATION STATEMENT

(taken from Article 8.3 of EBRD Model Law for Secured Transactions)

1. Name, address and other identification as necessary of charger/pledgor

2. Name, address and other identification as necessary of person owing the secured debt {if not the charger/pledgor}

3. Name, address and other identification as necessary of chargeholder/pledgee

4. Name address and other identification as necessary of charge manager (if appointed)]

5. Identification of the secured debt

6. Maximum amount of the secured debt

7. Identification of the charged/pledged property

8. {If appropriate} the charge/pledge is an enterprise charge/pledge {as defined in the Model Law}

9. Date of the charging/pledge instrument {except where an unpaid vendor's charge is being converted into a registered charge}

10. Where an unpaid vendor's charge/pledge is being converted into a registered charge/pledge

- 10.1 This registration statement is for the conversion of an unpaid vendor's charge/pledge

into a registered charge/pledge.

10.2 Date on which charged/pledged property was transferred to the chargeholder/pledgee

10.3 Date and identification of the written agreement giving rise to the unpaid charge/pledge

11. Where a possessory charge/pledge is being converted into a registered charge/pledge

11.1 This registration statement is for the conversion of a possessory charge/pledge into a registered charge/pledge

11.2 Date on which possession of the charged/pledged property was given {if later than the date of the charging Instrument}

Signature of charger/pledgor

Signature of charge/pledge manager
(if appointed)

{Or where an unpaid vendor's charge/pledge or a possessory charge/pledge is being converted into a registered charge/pledge}

Signature of chargeholder/pledgee

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