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Draft Practice Guide to the UNCITRAL Model Law on Secured Transactions: Annotated List of Contents

Note by the Secretariat

Contents

			Page
I.	Introduction		3
II.	Preliminary considerations		3
	A.	Intended audience	3
	B.	Scope	4
	C.	Structure	4
	D.	Style	5
III.	Annotated list of contents		5
	A.	Introduction	6
		1. Benefits of the Model Law	6
		2. Key terms	7
		3. Interaction of the Model Law with other laws of the enacting State	7
	B.	Contractual and transactional issues	8
		1. Secured finance under the Model Law: the fundamentals	8
		2. Types of secured transactions under the Model Law	10
		3. How to search in the registry	11
		4. How and where to register a notice	11
		5. How to enforce a security right	11
		6. How to collect receivables subject to an outright transfer	12
		7. How to transition prior security rights to the Model Law	12

V.17-07155 (E)

C. Regulatory issues 12
1. Introduction 12
2. Secured transactions law and capital requirements 12
3. Movable assets rights as eligible collateral under Basel Accords 13
4. Enhancing coordination: regulatory strategy 13
D. Financing of micro-businesses 14
1. Introduction 14
2. Common features of micro-businesses 14
3. Types of microfinance transactions 14
4. Issues specific to micro-businesses in the implementation of the Model Law . . 15
5. Regulatory capacity issues 15

I. Introduction

1. At its fiftieth session (Vienna, 3-21 July 2017), the Commission considered two notes by the Secretariat (A/CN.9/913 and A/CN.9/924) reflecting the deliberations and conclusions of the Fourth International Colloquium on Secured Transactions (Vienna, 15-17 March 2017). In addition, the Commission considered a proposal by the Governments of Australia, Canada, Japan and the United Kingdom of Great Britain and Northern Ireland (A/CN.9/926) that the Commission should prepare a practice guide for potential users of the UNCITRAL Model Law on Secured Transactions (the "Model Law") with respect to contractual, transactional and regulatory issues related to secured transactions, as well as financing of micro-businesses.[1]

2. At that session, there was general support for the preparation of a practice guide to the Model Law. It was widely felt that, without guidance on many practical issues, users of secured transactions laws implementing the Model Law (for example, parties to secured and related transactions, third parties affected by those transactions such as other creditors and insolvency administrators, legal advisors to those parties, judges, arbitrators, regulators, law teachers and researchers) would not be able to fully utilize those laws to their benefit. It was agreed that a practice guide could potentially address the following issues: (a) contractual issues (such as the types of secured transactions that would be possible under laws implementing the Model Law); (b) transactional issues (such as the valuation of collateral); (c) regulatory issues (such as the conditions under which movable assets are treated as eligible collateral for regulatory purposes); and (d) issues relating to finance to micro-businesses (such as the enforcement of security interests).[2]

3. After discussion, the Commission decided that a practice guide to the Model Law (the "draft Practice Guide") should be prepared and referred that task to Working Group VI. It was also agreed that the issues addressed in document A/CN.9/926 and the relevant sections of document A/CN.9/913 should form the basis of that work. The Commission further agreed that broad discretion should be accorded to the Working Group in determining the scope, structure and content of the draft Practice Guide.[3]

4. Parts II and III of this note contain an indicative list of issues that the Working Group may wish to consider in embarking on the preparation of the draft Practice Guide.

II. Preliminary considerations

5. The Working Group may wish to discuss and reach a working assumption on a number of preliminary issues before embarking on the preparation of the draft Practice Guide. Among others, the Working Group may wish to consider the intended readers of the draft Practice Guide, its scope, structure and style.

A. Intended audience

6. In view of the general support in the Commission for the draft Practice Guide providing guidance to users of secured transactions laws implementing the Model Law (see para. 2 above), the Working Group may wish to consider the target audience and thus, the purpose of the draft Practice Guide.

7. In this connection, the Working Group may wish to consider whether: (a) the draft Practice Guide in its entirety should be addressed to all potential users equally;

[1] *Official Records of the General Assembly, Seventy-second Session, Supplement No. 17* (A/72/17), paras. 220-221.
[2] Ibid., paras. 222-223.
[3] Ibid., para. 227.

or (b) different parts of the draft Practice Guide should be addressed to different audiences. If the latter approach were taken, the section on contractual and transactional issues could primarily be addressed to secured creditors, grantors, third parties affected by transactions, their respective lawyers, and adjudicators, while the section on regulatory issues could primarily be addressed to regulated secured creditors and regulatory authorities supervising financial institutions.

8. The Working Group may wish to also consider whether the draft Practice Guide should be prepared mainly for users who are familiar with the secured transactions regime contemplated by the Model Law or for users who are unfamiliar with that regime so as to assist them in development of knowledge on the Model Law and the utilization of the Model Law to their benefit.

9. The Working Group may wish to confirm that the draft Practice Guide should provide guidance to users from all legal traditions and regions. In relation, the Working Group may wish to consider whether the draft Practice Guide should include a comparison of the Model Law's unitary, functional and comprehensive concept of security with traditional concepts of security found in different legal systems. Such a comparison could assist users in understanding the objectives of the Model Law and how they are achieved through the implementation of the Model Law.

B. Scope

10. The Commission decided that the draft Practice Guide should address: (a) contractual and transactional issues; (b) regulatory issues; and (c) issues relating to finance to micro-businesses. The Working Group may wish to consider the precise scope of the issues to be addressed in the draft Practice Guide.

11. With respect to contractual and transactional issues, the Working Group may wish to consider whether the draft Practice Guide should cover the wide range of secured transactions or instead focus on some key transactions (for example, those involving core commercial assets, such as equipment, inventory or receivables).

12. As the main aim of the draft Practice Guide would be to provide guidance on secured financing, the Working Group may wish to consider the extent to which the draft Practice Guide should deal with financing in general. For example, the draft Practice Guide could provide some guidance on the fundamentals of good lending practices, while noting that the Model Law would not apply to unsecured lending.

13. With respect to regulatory issues, the Working Group may wish to consider precisely what topics the draft Practice Guide should address. For example, the draft Practice Guide could address the need to ensure coordination between secured transactions laws and the treatment of movable assets under the capital adequacy requirements imposed on regulated financial institutions by the regulatory law of a State enacting the Model Law. One reason for addressing this topic would be that lack of coordination might lead regulated financial institutions to treat transactions secured by movable property as being no better for capital adequacy purposes than unsecured credit. This would make it difficult for the Model Law to achieve its objective of enhancing access to credit. On the other hand, the Working Group may need to consider the extent to which it is appropriate and feasible to address this topic.

C. Structure

14. The Working Group may wish to consider how the information in the draft Practice Guide should be organized. For example, the Working Group may wish to consider:

(a) Whether the draft Practice Guide should be self-contained or contain material from the Model Law, the Guide to Enactment of the Model Law (the "Guide to Enactment") and other relevant texts, and, if so, to what extent;

(b) Whether the draft Practice Guide should include a short introduction to the Model Law and other relevant texts;

(c) How the draft Practice Guide should deal with the different types of transactions, secured creditors (e.g. regulated as opposed to unregulated, lenders as opposed to suppliers of goods on credit) and grantors (e.g. corporations as opposed to individuals, large businesses as opposed to micro, small and medium-sized businesses);

(d) Whether contractual, transactional and regulatory issues should be dealt with separately (as they are addressed to different audiences) or together; and

(e) Whether the discussion of issues affecting finance to micro-businesses should be dealt with separately, or as part of the general discussions of contractual, transactional and regulatory issues.

D. Style

15. The Working Group may wish to consider how the information in the draft Practice Guide should be presented to become a useful and practical tool containing a description of relevant issues and examples. For example, the Working Group may wish to consider:

(a) Whether the draft Practice Guide should use technical legal terms (which would keep the text concise and enable it to be more comprehensive) or be written in plain language to the extent possible (which would be easily readable by non-experts while there may be the risk of oversimplification);

(b) The extent to which the draft Practice Guide could include visual aids, such as text boxes, diagrams and flowcharts, to make the information in the draft Practice Guide more accessible to readers (acknowledging that there may be limitations due to translation into the other official languages of the United Nations and due to the publication rules of the United Nations);

(c) Whether each section of the draft Practice Guide should be self-contained, which may result in some repetition, or include references to other sections, as long as this does not make the text too difficult to follow or inconvenient to read;

(d) The extent to which the draft Practice Guide should refer to the relevant text of the Guide to Enactment and other UNCITRAL instruments on security interests to help readers understand the policy underlying the provisions of the Model Law;

(e) The extent to which the draft Practice Guide should refer to relevant texts of other international organizations;

(f) Whether the contents of the draft Practice Guide should be set out in the main body of the text or when appropriate, more detailed information could be included in the annex to the draft Practice Guide;

(g) The appropriate length of the draft Practice Guide (references could be made to the Guide to Enactment, the UNCITRAL Notes on Organizing Arbitral Proceedings and the UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation); and

(h) Whether the draft Practice Guide, like the Model Law and the Guide to Enactment, should be prepared as a publication (including electronically) or as an online resource, subject to obtaining a mandate and identifying available resources.

III. Annotated list of contents

16. The following sets out a possible list of contents of the draft Practice Guide for consideration by the Working Group, which would be subject to the discussions and

working assumptions reached by the Working Group on preliminary issues mentioned above.

A. Introduction

1. Benefits of the Model Law

17. This draft Practice Guide could explain the key benefits of the Model Law. The following paragraphs list some of the issues that could be addressed.

(a) Comprehensive scope of the Model Law

18. This section could explain that: (a) the generic concept of "security right" in the Model Law (the unitary approach) results in simplification of secured transactions law as it avoids the use of several concepts; (b) the functional approach of the Model Law ensures that all transactions that serve security purposes are covered; and (c) the comprehensive approach of the Model Law results in the secured transactions law being applicable to all types of grantors, secured creditors, encumbered assets and secured obligations.

19. This section could offer examples of certain types of transactions that are made possible under the Model Law, such as financing the purchase of equipment, revolving lines of credit secured by inventory and/or receivables of a business, term loans secured by grantor's assets generally or by its specific assets, leasing or factoring. In this connection, the Working Group may wish to consider which aspects of the Model Law should be emphasized.

20. This section could summarize the consequences of the extension of the scope of the Model Law to outright transfers of receivables. In many legal systems, the requirement of publicity for outright transfers of receivables would be a legal novelty. Therefore, it could be useful to explain how the requirement of registration and the application of the priority rules in the Model Law to outright transfers of receivables could protect all creditors.

(b) Party autonomy

21. This section could discuss the importance of party autonomy as recognized by the Model Law, in that it gives parties the ability to tailor their transactions to suit their specific circumstances. The limitations of party autonomy could also be highlighted.

(c) Comprehensive and coherent set of third-party effectiveness and priority rules

22. This section could summarize the main rules of the Model Law for determining the effectiveness of a security right against third parties, including competing secured creditors, transferees and lessees, judgment creditors and the administrator in the grantor's insolvency. The section could further illustrate the rules of the Model Law determining the order of priority between a security right and the rights of competing claimants.

(d) Efficient enforcement of security rights

23. This section could summarize the enforcement mechanism in the Model Law, explaining that secured creditors are given the option of enforcing its security right through court proceedings or out of court. It could also point out that the Model Law permits the grantor and the secured creditor to agree on different enforcement mechanisms, provided that their agreement does not prejudice the rights of third parties or the mandatory rights and obligations of the grantor, the secured creditor and other parties with rights in the encumbered asset under the enforcement chapter of the Model Law.

24. The section could further point out that an effective security right under the Model Law would remain effective in the grantor's insolvency, even though enforcement may be subject to a stay, or some other procedure that is prescribed by local insolvency law, which could delay or otherwise affect the enforcement process. The Working Group may wish to consider whether it would be helpful to include relevant references to UNCITRAL instruments on insolvency law and to explain how they and the Model Law work together on these aspects.

(e) Transparency of security rights: the registry as the cornerstone of the Model Law

25. This section could explain that for a security right to be effective against third parties under the Model Law, the secured creditor should, in principle, register a notice relating to its security right with the secured transactions registry. This section could also explain that notice registration provides a form of publicity of the possible existence of the security right, which reduces the risk of deception of third parties. It could explain how the search feature of the registry can be a powerful tool to enable a creditor to determine, before it extends credit, the priority that its security right will have as against competing claimants.

26. This section could explain the following key features of the registry system:

(a) Notice registration rather than document registration;

(b) Advance registration prior to the creation of a security right;

(c) Registration for third-party effectiveness purposes rather than creation of a security right;

(d) Registration and searching by the name or other identifier of the grantor; and

(e) Electronic registry for both registration and searching.

2. Key terms

27. This section could explain the key terms used in the Model Law, such as security right, security agreement, secured creditor, grantor and movable asset. The Working Group may wish to consider:

(a) Whether the list of terms should be expanded;

(b) The placement of this section in the draft Practice Guide; and

(c) Whether specialized terms should be explained in the context in which they are raised in the draft Practice Guide.

3. Interaction of the Model Law with other laws of the enacting State

28. This section could explain how the Model Law is intended to interact with other laws of the enacting State (such as its consumer protection or insolvency laws). The draft Practice Guide could reiterate the Guide to Enactment reminding legislators enacting the Model Law to ensure that other laws of that State are amended to the extent necessary for their laws as a whole to be consistent and function in a coordinated manner.

29. This section could also explain, for the benefit of regulators and regulated financial institutions, that the Model Law can affect capital adequacy calculations (see section C below for details). On the other hand, these matters and the different ways in which they may play out in the domestic context may raise too many complexities to lend themselves to adequate and satisfactory treatment in the draft Practice Guide.

B. Contractual and transactional issues

1. Secured finance under the Model Law: the fundamentals

30. This section could provide a general explanation of the importance of security in movable assets and the requirements for creating a security right. It could explain the key steps that creditors should take when engaging in a secured transaction. It could further explain the key stages in a simple secured transaction and why that is an effective and useful form of financing. Building on the explanations given for a simple type of transaction, the section could go on to describe more complex transactions, illustrating what else needs to be done or what needs to be done differently. The section could explain why each type of transaction is an effective and useful form of financing.

31. An example of a simple transaction could be a loan to fund the purchase of a car, a tractor or an item of machinery, with the security right being taken over that asset. While it is also a very common transaction, using this as an example has a disadvantage, as it engages a more complex priority rule (the rule for acquisition security rights) than transactions that rely simply on the "first-to-register" principle. For that reason, the Working Group may wish to consider whether transactions where the grantor owns the asset provided as collateral and is not seeking financing for its acquisition should be more appropriate examples to begin with.

32. The Working Group may wish to consider whether issues relating to the financing of micro-businesses need to be addressed in this section and if so, how.

(a) How to create and make effective against third parties a security right

33. This section could explain the basic requirements that must be satisfied for a secured creditor to obtain an effective security interest. This could focus on the technical requirements for the creation of a security right, in particular: (a) that the grantor has rights in the asset or the power to encumber it; and (b) that the secured creditor (in most cases) has entered into a written security agreement with the grantor. This section could further explain how the writing requirement could be met in electronic form.

34. Possessory pledges are a traditional way of creating a security right in a tangible asset. This section could explain how possessory pledges operate under the Model Law without the need to register a notice in the registry.

35. This section could also focus on making the security right effective against third parties, mainly by the secured creditor registering a notice in the registry. The Working Group may wish to consider whether the draft Practice Guide should also address more complex situations, for example, a party using a control agreement to make a security right in a bank account effective against third parties.

(b) Key preliminary steps for secured finance transactions

36. This section could describe the key steps that should be part of any secured finance transactions under the Model Law, regardless of the identity of the parties, the nature of the funding or the type of encumbered asset.

Due diligence on the customer

37. The Working Group may wish to consider whether any discussion of due diligence on the customer (the borrower or debtor) should begin with an acknowledgment that a lender should never make a loan to a customer if it expects that the customer will not be able to repay the loan and therefore, the lender will have to enforce its security right to be repaid. This discussion could emphasize that security rights should only be taken as a backstop, and a lender should always take steps to satisfy itself that its customer is both able and willing to repay the loan when due, without the lender needing to enforce its security right.

38. This section could then go on to describe steps that a lender could take to satisfy itself of this. Such descriptions could be detailed or simply point out key measures to be taken by the lender. In this connection, the Working Group may wish to consider that lenders will not be able to benefit fully from legislation implementing the Model Law if they do not have the skills to make wise lending decisions. On the other hand, it may be worth considering that the purpose of the draft Practice Guide is to explain how to utilize the Model Law and not to provide a training tool for general lending skills.

Due diligence on the asset to be encumbered

39. This section could list the steps that a lender should take to ensure that the asset being encumbered is suitable as collateral. Attention could be drawn to certain types of assets, especially those that are not generally accepted as collateral in many jurisdictions, such as inventory and receivables. The draft Practice Guide could mention the following steps that a lender should take:

(a) Verifying that the grantor owns or otherwise has rights in the asset;

(b) Valuing the asset (with guidance on how to value different types of assets);

(c) Assessing the availability and adequacy of a market on which it could sell the asset if it were to enforce its security right (with guidance on how a lender could dispose the collateral on such a market);

(d) Determining whether the asset is adequately insured;

(e) Investigating whether third parties may have competing interests (such as statutory preferential claims for unpaid taxes);

(f) Investigating whether the asset is located on a third party's premises, or held by a third party, in a way that might allow that third-party to assert a statutory preferential claim in the asset for amounts owing to it (for example, unpaid rent or service fees), and, if so, whether the lender could obtain a waiver or a subordination agreement from that third party; and

(g) Searching the registry to determine whether there are any prior security rights registered against the grantor that could apply to the asset (with guidance on what the lender could do if there are such registrations).

40. This section could point out that lenders often engage appraisers and other third parties to assist in the due diligence process.

Due diligence on any other credit and security support

41. This section could explain that secured creditors, in certain instances, also take other forms of credit support. These will often come from third parties, in the form of guarantees, letters of credit or credit insurance. This section could go on to explain that, in principle, the secured creditor should undertake the same level of due diligence on these third parties as it takes in relation to the debtor and the grantor, if different.

Documenting the terms of the finance

42. This section could explain that a lender should typically ask its customer to sign a document that sets out the commercial terms of the finance transaction. Depending on the circumstances, the document could address issues, such as:

(a) The obligation of the lender to complete the financing subject to the conditions set out in the document;

(b) The obligation of the borrower to cover the lender's costs of conducting due diligence, whether or not the transaction goes ahead;

(c) The terms of the finance, such as the amount of the loan, the duration, the interest rate and how often interest is to be paid, the repayment schedule, any financial

undertakings, and the circumstances in which the loan may need to be repaid early (often referred to as events of default);

(d) What asset is to be provided as security and by whom; and

(e) The fees of the lender.

43. Depending on the jurisdiction and the type of transaction, this information could be contained in a formal credit agreement or something simpler, such as a proposal letter by the lender. Such information may also be contained in several documents and this section could outline different ways in which the information might be documented in practice.

44. Rather than setting out too much detail in the text of the draft Practice Guide, a template of such documents could be set out in its annex. Templates for different types of transactions could be provided. Such templates could then be annotated explaining the relevance of their provisions and options, which would assist lenders in working out how to apply them to their own needs and circumstances.

Security agreement

45. This section could explain how a lender and a borrower could prepare their security agreement. The Working Group may wish to consider whether the draft Practice Guide should include an annotated sample security agreement and if so, whether samples of different types of transactions should be provided.

Closing the deal

46. This section could explain the steps that are normally involved in closing a secured finance transaction, such as:

(a) Registering a notice in the registry (and any follow-up to confirm that the notice has been registered and that no other relevant notice has been registered);

(b) Ensuring that the grantor has executed all the relevant documents; and

(c) Disbursing funds.

Monitoring collateral

47. This section could emphasize the importance of the lender paying attention to the customer even after funding has been provided. This could include steps such as monitoring the grantor's ongoing legal and financial status as well as the location, condition and value of the encumbered asset, including whether the grantor continues to own it.

2. Types of secured transactions under the Model Law

(a) Loan secured by an asset to be purchased with that loan

48. This section could provide an illustration of a loan that is made to purchase an asset with security being taken over that asset. This section could discuss how the rules of the Model Law apply to this type of transaction and offer an annotated template of a loan agreement and a security agreement. In doing so, the Working Group may wish to consider the extent to which the discussions in section B.1.b on key steps for secured finance transactions would need to be repeated to highlight the specific aspects of such transaction (this would also apply to other transactions mentioned below).

(b) Loan secured by all of the grantor’s movable assets

49. This section could provide an illustration of a loan to a business, secured against all its present and future assets. The loan could be a term loan or a revolving line of credit.

(c) Revolving loan secured by the grantor's inventory and receivables

50. This section could provide an illustration of where the borrower requests a loan to purchase raw materials for manufacturing and repays the loans as the manufactured goods (inventory) are sold, receivables are generated and collected. Thus, borrowings and repayments are frequent (although not necessarily regular) and the amount of credit is constantly fluctuating. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle, this type of loan structure is, from an economic standpoint, highly efficient and beneficial to the borrower. It also helps the borrower to avoid borrowing more than it actually needs, thereby minimizing financial costs.

(d) Other types of transactions

51. If the Working Group decides that the draft Practice Guide should illustrate other types of transactions, it could include, for example:

(a) Inventory finance provided by a supplier (which in many jurisdictions is structured as a sale of goods on retention-of-title terms);

(b) Lease finance for an item of capital equipment;

(c) Factoring and other purchases of receivables;

(d) The use of intellectual property as encumbered asset (in itself or as part of a transaction that involves a loan secured by all of the grantor's movable assets or as part of equipment or inventory finance where the equipment or inventory includes an intellectual property right); and

(e) The use of negotiable documents as encumbered asset (including, perhaps, an explanation of how the Model Law interacts with the Geneva Uniform Law for Bills of Exchange and Promissory Notes, where applicable).

3. How to search in the registry

52. This section could explain how to conduct a search of the registry (possibly with reference to the sections on due diligence) and how to understand the search results. This section could include some explanation of the limitations inherent in any search result (i.e. that it will not necessarily indicate that the grantor owns its inventory or receivables and not provide the searcher sufficient information to make a risk assessment without conducting further off-record inquiries). This section could further explain what other steps a searcher can take to obtain more information, if it discovers a potentially relevant result in its search.

4. How and where to register a notice

53. This section could explain how a secured creditor can make its security right effective against third parties by registering a notice in the registry. This section could also explain how and when a secured creditor may wish or need to amend or terminate its registration, illustrating that the Model Law provides two options for the retention of notices in the registry record (see article 30 of the Model Registry Provisions).

54. By explaining the key provisions in chapter VIII of the Model Law (Conflict of laws), this section could explain in which jurisdiction a secured creditor would need to register a notice.

5. How to enforce a security right

55. This section could explain how a secured creditor can use different enforcement mechanisms provided in chapter VIII of the Model Law (Enforcement of a security right) and how they would apply to different types of collateral (including all-asset securities). This could include guidance on identifying markets on which the secured creditor could dispose of the collateral.

56. The draft Practice Guide could also provide annotated templates of various notices that the secured creditor would need to give during the enforcement stage (e.g. under article 78, para. 4), when appropriate.

6. How to collect receivables subject to an outright transfer

57. This section could explain that a transferee of receivables under an outright transfer is not subject to the enforcement rules in the Model Law, because there is no secured obligation to recover. It could explain how such a transferee can collect the receivable. The draft Practice Guide could possibly include templates for relevant notifications and payment instructions.

7. How to transition prior security rights to the Model Law

58. This section could explain what measures a secured creditor would need to take to preserve the third-party effectiveness and priority of its security right created before a new law implementing the Model Law comes into effect, whether or not it was treated as a security right under the prior law.

C. Regulatory issues

1. Introduction

59. The following sets forth some of the issues that the Working Group may wish to consider including in the draft Practice Guide as touching upon the regulatory dimension of secured transactions law. For example, this section could explain how national regulatory authorities could support the implementation of the Model Law, in line with international capital regulation. This section could also explore the practicalities of establishing secondary markets for different types of assets, to make it easier for secured creditors to dispose of encumbered assets on default, and thus enable secured creditors to value the encumbered assets with more accuracy. In general, this section could briefly explain the regulatory environment that would be favourable to transactions covered by legislation implementing the Model Law, thus supporting the overall economic objective of that legislation.

60. As mentioned above (see para. 7 above), the primary audience of this section could be national regulatory authorities and regulated financial institutions subject to capital requirements. It could also target donor and reform-oriented agencies which assist States with the implementation of a modern secured transactions regime, but face challenges devising adequate solutions to stimulate secured lending by regulated financial institutions because of the lack of proper coordination between the secured transactions law and capital requirements.

2. Secured transactions law and capital requirements

61. This section could briefly explain why coordination between capital requirements and secured transactions law is necessary. If they are not properly coordinated, regulated financial institutions that must abide by capital adequacy standards are likely to treat loans secured by movable assets in the same manner as unsecured loans. As a result, such financial institutions are discouraged from extending credit with movable assets as security. Particularly, assets commonly utilized in the types of transactions that the Model Law seeks to promote, such as inventory, farm products and equipment, are generally disregarded or undervalued as eligible collateral under capital requirements.

62. Noting that the capital requirements laws often adopt different terminology, the Working Group may wish to consider the extent to which the draft Practice Guide could use terminology more familiar to regulatory authorities (for example, physical collateral instead of tangible asset). In that context, this section could identify and explain the key terms used in capital requirements law, such as collateralized

transaction, technique for credit risk mitigation or eligible collateral, and their relationship to the concepts and terms underlying the Model Law.

3. Movable assets rights as eligible collateral under the Basel Accords

63. On the assumption that a State has adopted or intends to implement both the Model Law and the Basel Accords issued by the Basel Committee on Banking Supervision, this section could discuss ways in which transactions secured with movable assets could reduce credit risk in line with the capital requirements with which regulated financial institutions must comply. In line with the Basel Accords, the draft Practice Guide could discuss ways of ensuring that the risk-weightings attributed to transactions secured with movable assets reflect the actual level of risk taken by regulated financial institutions.

64. By introducing key concepts, this section could explain the main mechanisms for movable assets to count as eligible collateral under the Basel Accords. An example of one such explanation is offered below.

65. Under the Basel Accords, for each loan, regulated financial institutions must calculate a capital charge that is a part of the overall regulatory capital. Capital charges are calculated through a risk-based approach. Risk weights are used to determine capital charges. Different risk weights are attributed different classes of claims, which are inserted into the formula used to calculate capital requirements. As a result, the higher the risk weights are, the higher capital charges will be.

66. Under the Basel Accords, there are three methodologies that regulated financial institutions may adopt to calculate credit risk and determine the core component of capital charges. They are: (a) the standardized approach; (b) the foundation internal rating-based approach; and (c) the advanced internal rating-based approach. Under the standardized approach, risk weights are predetermined and applied to different classes of exposures. The two internal rating-based approach variants allow regulated financial institutions to adopt, upon approval from the relevant national authorities, their own statistical estimations to calculate risk-weighted capital charges.

67. Under any methodology, secured transactions belong to the category of credit-risk mitigation techniques and represent funded credit protections. When credit protections are employed, the resulting risk-weighted charge can be lower than those that are imposed for an otherwise identical transaction that does not employ credit protection.

68. For financial institutions that follow the standardized approach, tangible assets (referred to as “physical collateral”) and receivables are not included in the list of recognized eligible collateral. This means that financial institutions may still take those assets as collateral, but that this will not translate into lower capital charges.

69. The advanced internal rating-based approach is more amenable to movable assets. Therefore, a regulatory and legal environment that facilitates the use of movable property as collateral should encourage financial institutions to adopt the advanced internal rating-based approach, in line with sound risk management.

4. Enhancing coordination: regulatory strategy

70. This section could discuss how national regulatory authorities can ensure that the criteria established by the Basel Accords are more easily met by regulated financial institutions. The main points that this section could address are listed below.

(a) Regulatory interventions

71. This section could include recommendations for measures that national regulatory authorities may consider implementing to facilitate loans secured by assets that form the typical borrowing base of small and medium-size enterprises.

(b) Promoting legal certainty

72. This section could discuss commonalities in which the Model Law and the Basel Accords promote legal certainty with respect to movable assets as eligible collateral, as well as differences, for example, with respect to the requirement of the latter for a specific description of collateral in a security agreement.

(c) Emphasizing the importance of the establishment of secondary markets

73. This section could explain the importance of sufficiently liquid secondary markets for the disposal of encumbered assets whether before or after default. With regard to the latter, while secured transactions law may provide for expeditious remedies, the lack of a readily available secondary market could make a lender reluctant to take the asset as collateral. The transparent price discovery is an important requirement for security over that collateral both to determine a loan to value ratio, as well as to reduce capital charges. This section could explore the use of various technologies to establish platforms and other virtual markets. This section could then go on to indicate how national regulatory authorities could promote the creation of transparent secondary markets where collateral can be disposed of.

(d) Data acquisition and capacity-building

74. This section could indicate how national regulatory authorities could incentivize financial institutions to generate more data and develop sound internal approaches to enhance the eligibility of movable assets as providing an effective technique for credit risk mitigation.

D. Financing of micro-businesses

1. Introduction

75. The Working Group may wish to consider whether the issues relating to financing of micro-businesses should be dealt together with contractual, transactional and regulatory issues or separately as outlined below.

76. The Working Group may also wish to take into account the work of Working Group I and in particular document A/CN.9/WG.I/WP.107 on reducing the legal obstacles faced by micro, small and medium-sized enterprises (MSMEs).

2. Common features of micro-businesses

77. This section could discuss some common features of micro-businesses and issues relating to their financing. Micro-businesses are usually either individual entrepreneurs or small family businesses, and loans are usually of low value, whether term loans or revolving facilities.

3. Types of microfinance transactions

78. This section could discuss the various types of transactions that are particularly suitable for micro-businesses (unsecured or secured by proprietary security rights or personal guarantees). Other possible transactions include inventory and receivables financing.

79. This section could also discuss personal guarantees, which are often given by family, friends or mutualized organizations of micro-businesses, and raise issues of protection of the guarantor (such as problems raised by household insolvency and the coordination of insolvency proceedings). In this connection, one of the questions that the Working Group may wish to address is the interaction between personal guarantees and secured lending.

4. Issues specific to micro-businesses in implementation of the Model Law

80. This section could discuss issues specific to micro-businesses in relation to the implementation of the Model Law. The following outlines some examples.

(a) Notifications

81. One example would be with regard to notifications to be sent to the grantor under the Model Law (e.g. Registry Provisions, article 15, paragraph 2, and Model Law, article 77, paragraph 2 (b), article 78, paragraph 4 and article 80, paragraph 2 (a)) and the address to which such notifications should be sent. When the grantor is a registered business, it will usually have an official address to which notifications can be sent and the secured creditor can be reasonably sure that the grantor will receive it or will not be able to deny that it had received it. When the grantor is an individual, particularly a sole trader, its address may change frequently and the secured creditor will not necessarily know about this change. The same applies to email addresses of individuals, where electronic notifications are permitted.

(b) Enforcement

82. Another example would be with regard to the enforcement of a security right in an asset offered as collateral by a micro-business or where an individual gives a guarantee. For example, it may be necessary to consider the protection of personal assets on enforcement. In addition, the out-of-court remedies provided in the Model Law may be too complicated and costly for very low-value loans. In relation to enforcement of security rights securing very small loans, a simplified out-of-court procedure may be needed with some built-in protection for the debtor. To facilitate enforcement, a small-claims court model with limited access to appeal or the use of alternative dispute resolution (whether physical or online) could be envisaged.

5. Regulatory capacity issues

83. This section could discuss how inequality of bargaining power in microfinance transactions can lead to unfair terms in loan and security agreements. High default interest rates, unfair termination clauses and other unfair terms could be discussed along with ways to address them.

84. The regulation of bank behaviour in relation to financing of micro-businesses could also be discussed. For example, it could be noted that the small size of loans reduces incentives on lenders to do a proper risk assessment, which often results in over-collateralization and deficient monitoring and reaction in the case of distress or default.