CHAPTER 6

Financial Infrastructure

Financial infrastructure consists of credit reporting systems (public credit registries and private credit bureaus), collateral and insolvency regimes, accounting and auditing standards, and payment and settlement systems. A well-developed financial infrastructure enables effective operation of financial intermediaries by reducing information asymmetries and legal uncertainties, which increase risk to lenders and impede the supply of credit. Improving financial infrastructure can increase access to finance for all, particularly consumers and small and medium enterprises, as problems of opacity and information asymmetry are more severe for them.

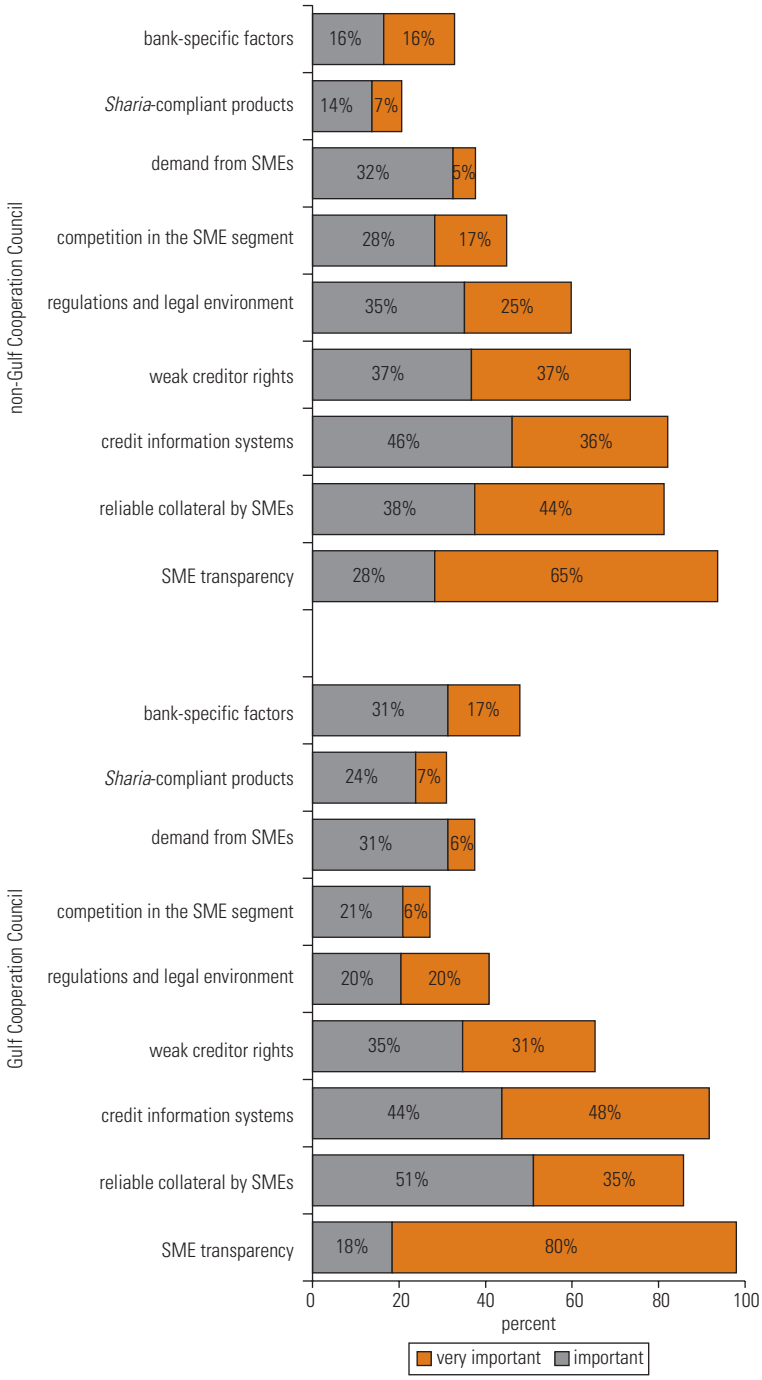
MENA has much weaker financial infrastructure than other regions. Its weaknesses, reflected in all the main relevant indicators, are highlighted in a recent survey of lending to small and medium enterprises in the region (Rocha and others 2011). MENA banks complain primarily about the opacity of small and medium enterprises and weak financial infrastructure (lack of reliable collateral, weak credit information systems, and weak creditor rights) (figure 6.1). The contrast with other surveys is striking. In global surveys (Beck, Demirgüç-Kunt, and Martinez Peria 2008) and surveys of Latin America (de la Torre, Martinez Peria, and Schmukler 2010), banks identify many obstacles to small and medium enterprise lending, including macroeconomic factors, regulations, and excessive competition; they complain less about the quality of financial infrastructure.[1]

This chapter reviews the status of financial infrastructure in the region and identifies the main design and regulatory challenges. It focuses on credit information and creditor rights because the focus of the report is on access.

The chapter is structured as follows. The first section gives an overview of credit reporting systems and assesses these systems in MENA. The second section discusses collateral regimes in MENA and highlights weaknesses in the secured lending chain. The last section

FIGURE 6.1

Results of Survey on Importance of Obstacles to Lending to Small and Medium Enterprises, 2009



Source: Rocha and others 2011.

Note: SME = small and medium enterprises.

provides an overview of insolvency regimes in the region, summarizing the main problems.

Credit Reporting Systems

Credit Reporting Systems outside the Region

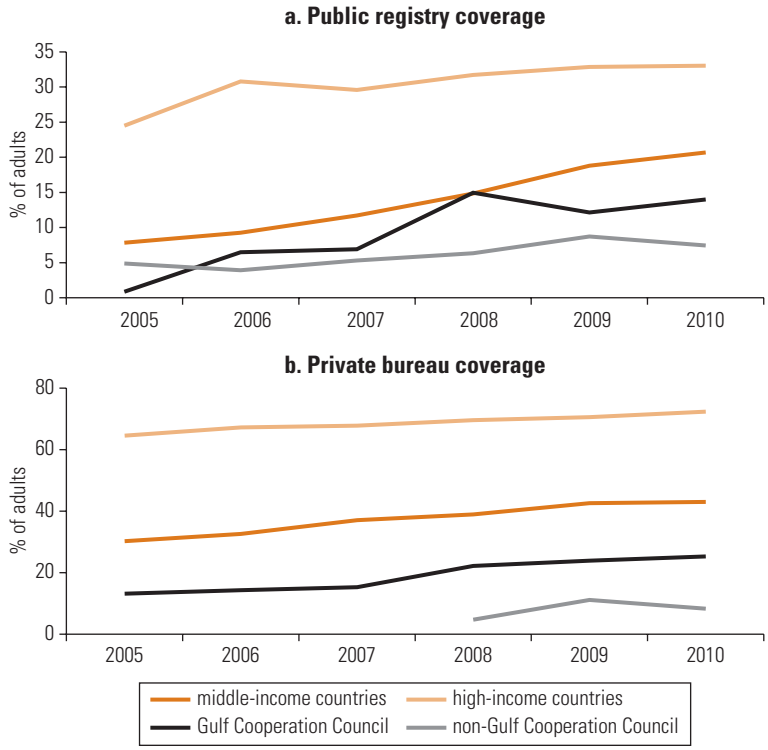
Public credit registries and private credit bureaus form the core of a country's credit reporting system.[2] Public credit registries are managed by central banks or bank supervisors. They mainly collect information from supervised institutions. Private credit bureaus are generally owned by private international or local providers, with rare involvement of public entities. Because participation in public credit registries is mandatory, these institutions can build a picture of the regulated financial system relatively quickly and support supervisory functions. In contrast, private credit bureaus typically collect a greater volume of both positive and negative information from all sectors with more accuracy and detail. They thus develop a more complete picture of a borrower's financial dealings, especially if provision of data is mandatory.

Public credit registries can jump-start credit reporting in a country and play an important role in the early stages of financial development. Public credit registries are in operation in about 80 countries, but almost half of the countries that rely only on public credit registries are low-income countries in Africa (see table 5.1 in chapter 5). In contrast, less than 8 percent of high-income countries rely exclusively on public credit registries. Private credit bureaus have been established in about 80 countries; most middle- and high-income countries rely on private credit bureaus or a combination of private credit bureaus and public credit registries.

Several middle-income countries have retained their public credit registries, but the large gains in coverage and depth of information have been achieved by private credit bureaus. The average coverage ratios of private credit bureaus are twice those of public credit registries for high- and middle-income countries (note the different scales in figure 6.2). Moreover, private credit bureaus substantially improve the depth of credit information. Most public credit registries outside MENA collect data from regulated financial institutions; a much smaller share collects data from other institutions, including microfinance institutions (figure 6.3). Private credit bureaus collect information not only from banks but also from nonfinancial data providers (retailers, utilities, credit card issuers, mobile telephones). Improvements in data collection from microfinance institutions are noteworthy, with the share of private credit bureaus worldwide collecting

FIGURE 6.2

Coverage of Public Credit Registries and Private Credit Bureaus, by Country Group, 2005–10



Source: World Bank 2006–11.

data from these institutions increasing from 8 percent in 2005 to 58 percent in 2010.

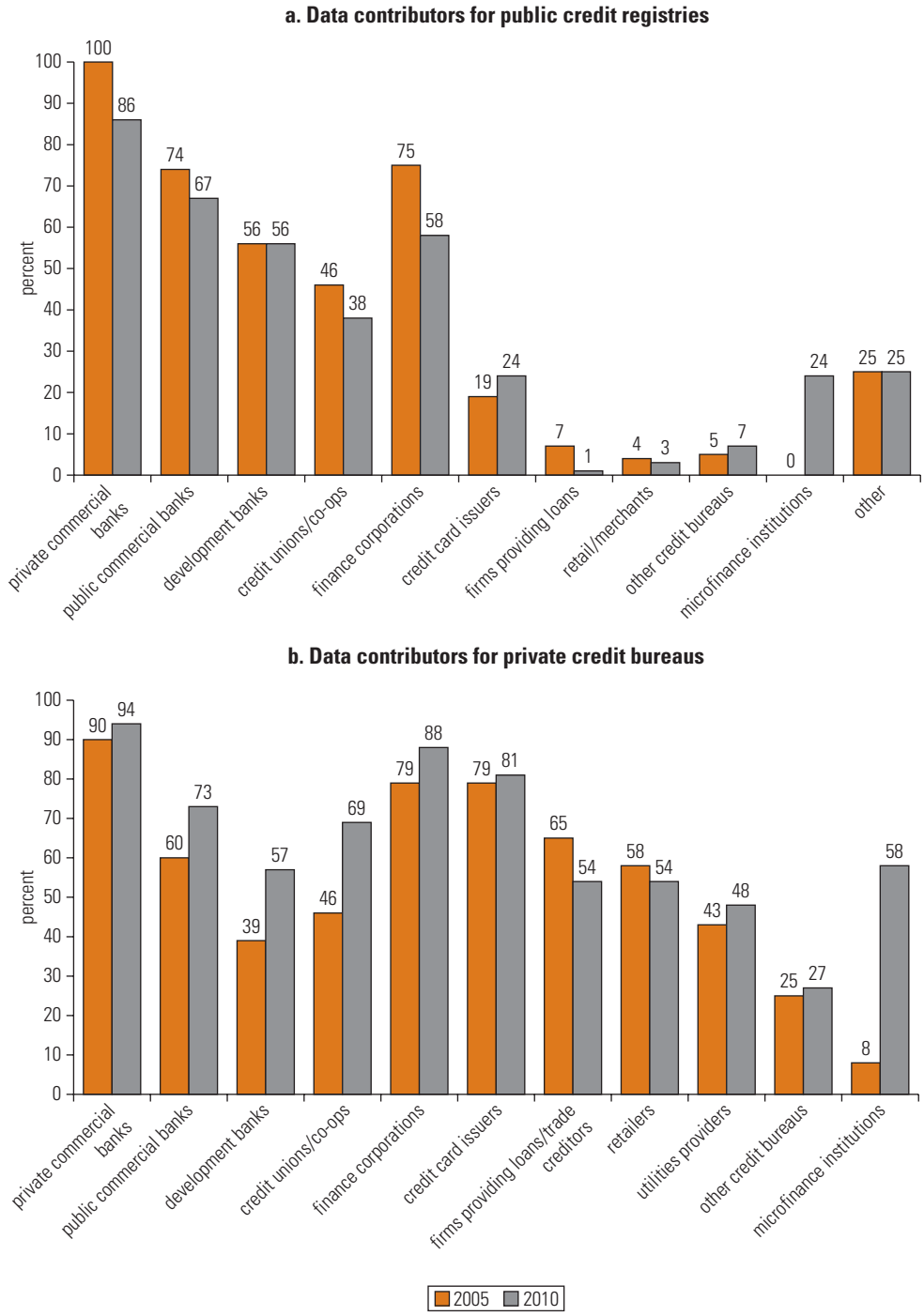
In addition to providing raw information in the form of credit reports, private credit bureaus can develop a range of value added services thanks to the wealth of information they collect. Provision of credit bureau scores and ratings of small and medium enterprises can help lenders make better decisions about new credit applicants. The development of value added services generally represents a more advanced phase in the activity of a private credit bureau; it requires sufficient historical data and an adequate evolution of the market.

Credit Reporting Systems within the Region

About 60 percent of countries in the region still rely entirely on public credit registries, a larger percentage than all regions except Africa. The establishment of private credit bureaus in MENA is a relatively recent

FIGURE 6.3

Institutions Providing Data to Public Credit Registries and Private Credit Bureaus, 2005 and 2010



Source: World Bank 2005, 2010.

phenomenon. Ten economies in the region still rely entirely on public credit registries; four rely entirely on private credit bureaus (Bahrain, Kuwait, Morocco, and Saudi Arabia); and three have both public credit registries and private credit bureaus (the Arab Republic of Egypt, the Islamic Republic of Iran, and the United Arab Emirates) (table 6.1).

The introduction of new private credit bureaus and the upgrading of some public credit registries have increased the depth of credit information in MENA. New private credit bureaus have been introduced in Bahrain, Egypt, Morocco, Saudi Arabia, and the United Arab Emirates; Lebanon, Tunisia, and the United Arab Emirates have improved their public credit registries; and Oman and the West Bank and Gaza have introduced new, modern public credit registries. These improvements resulted in a significant increase in the credit information index for MENA, which rose from 1.8 in 2005 to 3.2 in 2010 (World Bank 2010). The range of institutions providing information to registries and bureaus has also increased since 2005, although there is substantial room for improvement.

Although the architecture of credit information in MENA is improving, much remains to be done. Coverage, especially of public credit registries, remains low (see figure 6.2). The average coverage of private credit bureaus is more than twice that of public credit registries, but it remains substantially lower than in emerging economies. The low coverage is explained largely by the fact that most private credit bureaus are new and just starting to expand their operations; it could also reflect lack of sufficient regulatory efforts to encourage the more rapid engagement of unregulated institutions, including microfinance institutions.

TABLE 6.1

Public Credit Registries and Private Credit Bureaus in the Middle East and North Africa

Public credit registry and private credit bureau	Private credit bureau only	Public credit registry only	Not available
Egypt, Arab Rep. (2008)	Bahrain (2005)	Algeria	Iraq
Iran, Islamic Rep.	Kuwait (2002)	Djibouti	
United Arab Emirates (2007)	Morocco (2009)	Jordan	
	Saudi Arabia (2004)	Qatar	
		Lebanon	
		Oman	
		Syrian Arab Republic	
		Tunisia	
		West Bank and Gaza	
		Yemen, Rep.	

Source: World Bank 2010.

Note: Years in parentheses indicate year private credit bureau was established.

The number of institutions providing information to private credit bureaus, especially finance corporations and credit card issuers, has been increasing. Private credit bureaus have also started collecting information from nonbank and unregulated institutions; more effort is needed to collect information from microfinance institutions. These improvements in data collection should deepen as the young private credit bureaus consolidate their databases and expand their operations. In this regard, further efforts are needed to engage microfinance institutions, including efforts to improve and harmonize their less sophisticated information technology systems, as well as efforts to reduce the fees charged by these institutions. Private credit bureaus have also been able to gather more information on payments performance. A larger share of public credit registries provides information on bad checks, but a larger share of private credit bureaus provides positive information on other payment events, especially on-time payments.

Most public credit registries in MENA operate as traditional public credit registries, collecting information from regulated entities and disseminating the data to lenders in aggregate format. The functional and technological systems of public credit registries vary across the region. Most public credit registries were established to support bank supervision and still operate with this objective. However, a few new public credit registries (in Oman, the West Bank and Gaza) aim to offer the same quality and service as best-practice private credit bureaus. Some public credit registries (in Algeria, Lebanon, Tunisia, and the Republic of Yemen) have recently been upgraded or are in the process of being upgraded. Some (in Libya) have been established recently or are trying to make the big jump to paperless online technology (in Djibouti, the Syrian Arab Republic). These efforts are commendable, although the extent to which these public credit registries will be able to expand coverage and significantly improve the depth of credit information is open to question, as suggested by the experience of other countries (see figures 6.2 and 6.3).

The Palestine Monetary Authority (PMA) has established one of the most effective public credit registries in the region. It has pioneered credit reporting and educated lenders on the importance of sharing credit data. All banks and major microfinance institutions (representing more than 80 percent of the market) are part of the sharing scheme. Microfinance institutions are not regulated by the PMA but participate in the sharing scheme on the basis of a memorandum of understanding signed with the consent of the PMA and consumers. The private credit bureau provides users with a Web-based online facility for inquiries and data sharing. The credit report it provides is more like a private credit bureau report, displaying detailed information at the account level, including historical data, arrears, and account performance. The credit bureau has benefited

from technical assistance from an international private credit bureau to build a scoring model and aims to provide the same quality of service as a best-practice private credit bureau.

Credit scoring is still undeveloped in MENA, but some countries are making impressive efforts in this area. Less than half of the banks in MENA have some form of scoring model, and less than 30 percent rely on scoring methods for automated decisions. Credit risk assessment is generally centralized and relies excessively on high collateral. Credit applicants usually have to satisfy a long list of requirements, and credit underwriting is generally a lengthy process that can take 2–30 days. However, some private credit bureaus and public credit registries are developing credit scoring and rating models and promoting their use among banks. The private credit bureau in the West Bank and Gaza is building a scoring model, and the Moroccan private credit bureau is planning to build one. The Saudi Arabian private credit bureau may be the registry that has made the greatest progress in this area. In cooperation with commercial banks, it is building a database that generates probabilities of default at the sectoral level, allowing banks to benchmark the performance of their own portfolios. It has also built individual credit scores and, more recently, credit ratings for more than 20,000 small and medium enterprises, as part of a broader effort to develop more lending to such businesses.

Legal Framework for Credit Reporting

The development of the credit reporting industry in many countries in the region remains hindered by a weak legal framework. The legal framework plays a critical role in the development of credit reporting, as it can boost lenders' and consumers' confidence about data privacy. In some countries, the regulatory framework on information sharing systems remains fragile. Lenders and regulators in Lebanon, Syria, and Tunisia, for example, cite bank secrecy as one of the major constraints to establishing credit information infrastructure. A variety of legal approaches has been adopted to reach a fair balance between bank secrecy and information sharing. These approaches are briefly discussed below.

Credit bureau law

A customized law on private credit bureaus represents the best foundation for information sharing that enhances consumers' rights and develops a credit reporting system. Jordan opted for this approach in 2008 to reform its credit reporting system and establish its first private credit bureau. In May 2010, the government approved the credit information bureau law.

After years of credit reporting operations based on a simple code of conduct and consent model, Saudi Arabia approved a new credit reporting law in July 2008. In 2007, the United Arab Emirates drafted a credit reporting law, which was approved by the government in October 2010.

Central bank regulations

Some countries have adopted central bank regulations to establish a credit reporting system. This approach consists of regulations, not laws, approved by the banking supervisor that aim to regulate information sharing and clarify consumers' rights as well as the responsibilities of lenders and private credit bureaus. Noteworthy examples are the regulations adopted by the central banks of Egypt (in 2006) and Morocco (in 2007), enabling effective private credit reporting through different information sharing schemes (voluntary in Egypt, mandatory in Morocco).

Codes of conduct

Codes of conduct have been adopted in countries in which the banking authorities were not empowered to enact a specific credit reporting regulation or a specific law was not in place. The Saudi Arabian Monetary Agency (SAMA) initially encouraged the banks to establish a private credit bureau simply on the basis of consumers' consent and a code of conduct. It used its full moral suasion over lenders, encouraging the banks to start a private credit bureau even without a strong legal framework. The private credit bureau operated for years without any bespoke legislation or regulation. The Saudi Arabian authorities eventually concluded that a specialized law would provide a much sounder legal basis for credit reporting and introduced such a law in 2008. Other countries, such as Bahrain, have also adopted a code of conduct model accompanied by consumers' consent.

Collateral Regimes

Secured transaction systems are still very underdeveloped in MENA, which ranks last among world regions in the area of creditor rights, as measured by the legal rights index (table 6.2).[3] On average, more than 80 percent of loans granted in MENA require some form of collateral (World Bank 2006–10). In-depth analysis indicates that the source of the problem is not the availability of collateral but the ability to translate valuable assets into productive use. MENA lacks the legal framework that would allow enterprises to use their movable assets as collateral.

MENA countries have weaknesses in all components of the secured lending chain. A survey of 140 MENA banks asked if they experienced

TABLE 6.2

Legal Rights Index, by World Region

Region	Legal rights index
Organisation for Economic Co-operation and Development (OECD)	6.8
Europe and Central Asia	6.6
East Asia and Pacific	5.7
Latin America and the Caribbean	5.5
South Asia	5.3
Africa	4.6
Middle East and North Africa	3.3

Source: World Bank 2010.

Note: Scale ranges from 0 to 10.

difficulties in three components of the chain of secured lending: registration, enforcement, and the selling of collateral (Rocha and others 2011). Banks reported problems in all three components, especially for movable collateral (figure 6.4). Although a relatively small share of banks reports serious problems with the registration of fixed collateral, a large proportion reports that registries of movables remain very deficient. Enforcement of collateral is a bigger problem, especially for movables but also for fixed collateral in the case of banks in countries outside the Gulf Cooperation Council (GCC). An even larger share of both GCC and non-GCC banks reports problems selling seized fixed and movable collateral.

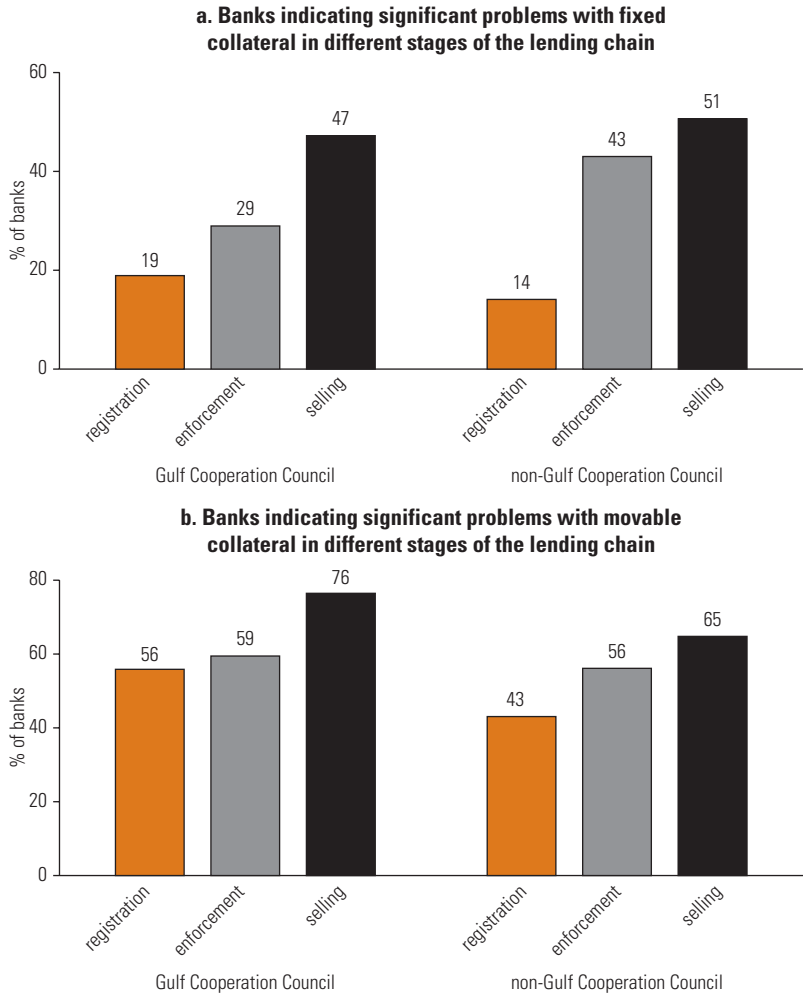
Scope of the Law

None of the countries in the region has a modern law on secured transactions. Most countries have obsolete and fragmented provisions for secured transactions that are governed by different laws that have not been reformed for many years. The range of assets that can be used as collateral is quite limited. Immovable property is still used as the prevalent form of collateral. With regard to tangible movable property, vehicles are a widely accepted form of collateral, as a result of the region's relatively well-developed vehicle registration framework. Only a few MENA countries allow inventories, receivables, securities, bank accounts, and salaries to be used as collateral.

An important obstacle in expanding the range of movable collateral is the requirement to describe each piece of collateral. Certain assets, such as inventory or accounts receivable, exist as a pool whose individual elements change on a daily basis. It is impossible to make new adjustments to a security agreement for each change. Advanced financial systems do not require borrowers to document each piece of collateral.

FIGURE 6.4

Percentage of Banks Indicating Problems with Fixed and Movable Collateral



Source: Rocha and others 2011.

Creation of Security Interest

In many countries in the region, the creation of enforceable security is cumbersome and includes formalities that make the system more burdensome. Lebanon, Oman, Saudi Arabia, Tunisia, and the Republic of Yemen, for example, require security interests to be registered in specific institutions (courts, notaries) in order to be enforceable. A credit agreement between debtor and creditor should be enforceable without any other requirements. A distinction should be made between enforceable

agreements and the priority of claims against third parties (for which registration in a public registry is necessary).

Registration of Collateral

MENA is possibly the only region in the world without a modern collateral registry system. Registries in several countries in the region tend to be depositories for documents that neither publicize security interests nor prioritize the rights of creditors. Most registries are decentralized (exceptions are Kuwait, Lebanon, Oman, and the West Bank and Gaza), with data registered in different locations (table 6.3). Moreover, most registries in MENA are paper based rather than electronic (Kuwait, which has a fully electronic registry, is the only exception). They are therefore not searchable by the public and do not help lenders or borrowers establish priority among security interests held by multiple lenders. Most registries limit the registration to a few types of movables (equipment, enterprise pledges) and do not provide information

TABLE 6.3

Mapping of Collateral Registries in the Middle East and North Africa

Economy	Collateral registry	Centralized	Electronic or paper based	Easily accessible to public for searches
Algeria	Various	No	Paper	No
Bahrain	Various	Only for commercial registry	Semielectronic	—
Egypt, Arab Rep.	Various	No	Paper	Somewhat
Iran, Islamic Rep.	Various	No	Paper	—
Iraq	No	No	—	—
Jordan	No	No	Paper	Somewhat
Kuwait	Ministry of Justice	Yes	Electronic	—
Lebanon	Various	Yes	Paper/electronic	—
Libya	—	—	—	—
Morocco	Various	No	Paper	Somewhat
Oman	Various	Yes	Paper/electronic	—
Qatar	Vehicles	No	—	—
Saudi Arabia	Various	No	Paper	—
Syrian Arab Republic	No	—	—	—
Tunisia	Various	No	Paper	—
United Arab Emirates	Not for movable collateral	No	—	—
West Bank and Gaza	Vehicles	Yes	Electronic	No
Yemen, Rep.	No	—	—	—

Source: World Bank 2010.

Note: — = not available.

on different types of security rights. A number of countries in the region have a variety of registries, depending on the type of movable collateral secured (vehicle, securities, enterprise charges, floating charges).

Priority Schemes for Creditors

A priority scheme for creditors consists of rules that determine the order in which competing claims against secured collateral can be executed in the case of default. An effective priority system should have a public policy for each priority and a clear set of rules regulating the order of priorities to facilitate these policies. The general priority rule used in more developed systems is based on notice and the "first to register rule" (meaning that the first party to register has priority over the collateral).

Priority schemes in the region do not provide clear and favorable laws and regulations for creditors (table 6.4). Proper priority systems are absent. They place secured creditors on top of the priority list when it comes to recovering assets and debts outside of bankruptcy. Countries should have a clear scheme that specifies the priority position of each creditor so that they can accurately assess the risk associated with taking collateral as security.

Enforcement of Collateral

Enforcement refers to the process for implementing a claim against collateral when the debtor defaults on a secured obligation. Enforcement mechanisms should be speedy and inexpensive. They can be made most effective when parties agree on rights and remedies upon default, including seizure and sale of the collateral outside the judicial process.

TABLE 6.4

Priority of Secured Creditors with Respect to Other Creditors, by World Region, 2010

Region	Percentage of countries providing absolute priority outside of bankruptcy
Europe and Central Asia	75.0
OECD	59.1
East Asia and Pacific	58.3
Latin America and the Caribbean	38.1
Africa	25.6
Middle East and North Africa	16.7
South Asia	14.3

Source: World Bank 2010.

An efficient procedure is particularly important for movable property, which usually depreciates in value over time. Under a nonjudicial enforcement mechanism, the secured creditor takes the property from the debtor without court assistance. Some jurisdictions have a prejudgment procedure in which, upon presentation of proof of the security agreement and default by the creditor, the court issues an order of seizure of the property. In other systems, the proof may be simply a sworn affidavit of the creditor.

Out of court enforcement procedures are nearly nonexistent in the region. Legislation in only three countries (Bahrain, the Islamic Republic of Iran, and Qatar) allows out-of-court procedures; there is no evidence on how the process works in practice. Few countries in the region have a framework for recovery of debts outside the judicial system. In fact, the region lags all other regions in this area (table 6.5). Although creditors constantly mention enforcement as a major issue, countries have not taken any concrete steps to resolve the problem. Some positive initiatives include Jordan's 2008 Leasing Law, which introduced out-of-court procedures for leased assets. It remains to be seen whether the law will be expanded to include other security interests in movable assets.

Enforcement of security through courts is a last resort for creditors: only when out-of-court options are not available should the creditor opt to take the borrower to court to recover debt. A modern secured transaction law should include procedures that are rapid enough to permit recovery before loss of value of the assets without undue risk of concealment or sale of assets by the debtor. Jordan, Lebanon, Morocco, Oman, and the United Arab Emirates report court enforcement that is time consuming, expensive, and unpredictable. In some countries, such as Tunisia, the fast-track processes in court to recover debts seem to be working well and could serve as models for other countries in the region.

TABLE 6.5

Existence of Out-of-Court Procedures for Enforcing Claims on Collateral Recovery, by World Region, 2010

Region	Percentage of countries
South Asia	85.7
OECD	77.3
Europe and Central Asia	75.0
East Asia and Pacific	58.3
Africa	41.0
Latin America and the Caribbean	33.3
Middle East and North Africa	16.7

Source: World Bank 2010.

Sale of Collateral

The disposition of secured assets is one of the major constraints facing financial institutions in MENA (figure 6.4). In many countries, collateral must be sold through a public or judicial auction that involves cumbersome rules and minimum bids that are often based on unrealistic values, making it difficult to dispose of the property. This constraint delays the sale, resulting in devaluation of the assets, and may not be appropriate for certain types of assets for which there are no organized and liquid markets. Although the problem is an issue for both movable and fixed assets, movable property is more difficult to sell after a default and the repossession of the asset. Private sales of secured assets, which are usually associated with extrajudicial enforcement mechanisms, are rare in MENA.

Insolvency Regimes

A healthy insolvency system provides predictability to debtors and creditors in case of financial distress while balancing liquidation and reorganization.[4] The lack of efficient exit mechanisms inhibits market entry, because entrepreneurs cannot be released from debts relating to previous failures. An insolvency procedure should be widely accessible: both debtors and creditors should be able to file for insolvency easily, and debtors should be provided opportunity to object to protect themselves from inappropriate creditor harassment. The rights of creditors and priorities of claims established before insolvency should be upheld to preserve the expectations of the economic agents. Although some new claims (such as costs of the administration of the estate) will take priority, in general the insolvency process should not undermine ordinary creditor priorities that exist outside of bankruptcy.

Reorganization is one of the most important features of a modern insolvency regime. In many countries, bankruptcy has historically been synonymous with liquidation. In a modern system, the insolvency system allows a potentially viable debtor company to attempt to reorganize and survive its financial distress in order to continue operations. Reorganization can help companies that are in distress but fundamentally viable, that is, companies that need time and some legal protection to survive and continue operating productively.

A modern insolvency regime must also include efficient liquidation procedures for nonviable enterprises. The most frequent use of bankruptcy is liquidation, a process through which the assets of a nonviable company in financial distress are sold to other economic agents and its

human capital (owners, employees) redeployed. Liquidation is invoked when attempts to reorganize a company in distress fail. Under such circumstances, conversion to liquidation should be swift and efficient.

Insolvency systems in MENA are by and large underdeveloped. One of the main problems is approaching debtors as wrongdoers rather than economic agents in distress. There is varying use and understanding of insolvency. Countries that have insolvency regimes usually use them as a tool for collection by creditors and the winding up of companies.

Some economies, including the Islamic Republic of Iran, Iraq, and the Republic of Yemen, do not have insolvency laws. Jordan does not have a cohesive bankruptcy law, although it has acquired practice in winding up companies drawing on provisions from several laws. Qatar, Saudi Arabia, the United Arab Emirates, and the West Bank and Gaza report very low usage of their bankruptcy systems. In contrast, Morocco and Tunisia are modernizing their bankruptcy regimes by adding commercial courts and insolvency training for judges.

The rights of creditors during bankruptcy proceedings are often unprotected in MENA countries. Rights that are given priority over creditors' rights as a matter of public policy are court costs, taxes, the costs of the estate, and debts to employees and servants. Egypt, Jordan, Kuwait, Morocco, and Qatar give higher priority to public policy exceptions, making it unclear if secured creditors' rights are preserved in insolvency.

There are few enterprise reorganizations in MENA countries, despite the fact that many countries have reorganization provisions in their laws. Most provisions are in the form of a conciliation procedure that allows a delay in the declaration of bankruptcy in order to reach an amicable settlement with creditors. One of the most important shortcomings is the lack of institutional capacity. Institutions, particularly courts, are inflexible and tend to be bureaucratic and formalistic. There is a lack of restructuring experts and insolvency professionals experienced with creditor negotiation and debt restructuring. The lack of experience with reorganization seems to be reinforcing the lack of its practice.

No MENA country can claim an efficient liquidation mechanism by international standards. Despite being the most commonly used procedure in the region, liquidation is a time-consuming process marked by delays and inefficiencies. Procedures for selling assets are not efficient and often require auctions with cumbersome procedures. Efficient recovery and maximization of assets is not the norm, and bankruptcy is seen as a last resort. Creditors often expect little or no recovery and use a bankruptcy declaration as a threat to motivate payment. Bankruptcy then becomes a tool for creditor collection, essentially a bilateral dispute over continuation or dismissal of the bankruptcy based on satisfying a debt.

Notes

1. Although the statistical analysis of the global data set revealed that the quality of the legal framework had an impact on small and medium enterprise lending (Beck, Demirgüç-Kunt, and Martinez Peria 2011).
2. This section is based on Madeddu (2010).
3. This section is based on de la Campa (2011).
4. This section is based on Uttamchandani (2010).

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