

The Relationship between the Development of Financial Markets and Security Interest Laws

Brian Duncan

Mahmood Bagheri*

☞ Financial markets; Perfection of security interests; Security

Abstract

This article will describe the developments in the financial markets as a result of the legislation of security interest laws by initially capturing the basic legal concepts of security interest. Thereafter, an analysis will be undertaken on the ever-evolving relationship between security interest and the financial markets globally while identifying both some notable benefits and some disadvantages that have been characteristic of this development. The discussion will briefly address some important considerations for the continued development of financial markets and their relationship with security interest laws.

Introduction

The relationship between a lender's monies and a borrower's collateral is based on one factor and that is the repayment of the debt. Although this concept has existed for a long time, the legal transactional mechanisms involved in the transfer of credit between the participants have evolved. The ability to create a security interest in

a property, among other factors such as the legal infrastructure and the market itself,¹ has allowed financial markets to evolve to a level that would not have been possible without the development of security interest and its role in international finance.²

The concept of security interest laws

In a borrower–lender relationship where the creditor is unsecured, there could exist a simple and desired outcome where the debtor repays his or her debt when it matures in accordance with the contractual arrangements; or the transaction itself could be more complicated, as will be discussed later.³ A real concern arises if the debtor breaches the loan agreement due to an inability to repay the creditor either out of choice or circumstance. This would compel the creditor to seek legal remedies to reclaim the monies owed by the debtor, which could become increasingly complicated if there are other creditors laying claim to that same debtor's assets.⁴ Therefore, creditors would be wise to require a security interest in the collateral⁵ prior to any monetary exchange in most circumstances as it serves as a contingency repayment method⁶ after salary or cash flow, depending on the category of the legally binding lending arrangement.⁷

The concept of security interest⁸ is a legal guarantee created over a property,⁹ tangible or intangible,¹⁰ which provides a creditor with a legal claim to the collateral in exchange for monies provided to a borrower.¹¹ This allows the secure exchange of assets in the event of a default by the borrower in repaying that debt obligation. Consequently, the creditor would have a legal right to dispose of that asset, within certain regulations, in order to satisfy the borrower's debt obligation. Secured lenders have priority rights to a collateral over unsecured creditors because unsecured creditors accept an increased risk of not collecting on any debt that they enter into.¹²

However, any attempt by the creditor to recover its monies through the exercise of its legal rights provided through the creation of a security interest in a debtor's

* Dr Mahmood Bagheri is currently a Senior Research Fellow and LLM course director in the Institute of Advanced Legal Studies, School of Advanced Study, University of London. He is also Associate Professor of Banking and Financial Law, University of Tehran. Dr Mahmood Bagheri can be contacted at: mahmood.bagheri@sas.ac.uk. Brian Duncan works at the Central Bank of Belize.

¹ Andrzej Rapaczynski, "The Roles of the State and the Market in Establishing Property Rights" (1996) 10(2) *Journal of Economic Perspectives* 87; Joseph J. Norton and Mads Andenas, *Emerging Financial Markets and Secured Transactions* (Leiden: Kluwer Law International, 1998), pp.16–34.

² Joanna Benjamin, *Interests in Securities: A Proprietary Law Analysis of the International Securities Markets* (Oxford: OUP, 2000), p.322.

³ Joseph H. Levie, "Security Interest in Chattel Paper" (1969) 78 *Yale L.J.* 935, 936–938.

⁴ Randal Picker, Douglas Baird and Thomas Jackson, *Security Interest in Personal Property—Cases, Problems, and Materials*, 3rd edn (Chicago: Foundation Press, 2002), p.3.

⁵ Collateral can either be legally categorised as the actual transfer of the collateral or the creating of the security interest. See Benjamin, *Interests in Securities* (2000), pp.82–84.

⁶ An over-reliance on collateral can lead to inadequate risk assessment by creditors which would eventually prove harmful to financial markets if this norm proliferates. See Pascale De Boeck and Thomas Laryea, "Development of Standards for Secured Transactions and Enforcement of Claims" (IMF, April 2003), p.2 available at: <http://www.imf.org/external/np/leg/sem/2002/cdmfll/eng/pdb.pdf> [Accessed 30 January 2017].

⁷ Gerard McCormack, "The essence and importance of security" (CUP, July 2009), p.10 available at: http://assets.cambridge.org/9780521826709/excerpt/9780521826709_excerpt.pdf [Accessed 30 January 2017].

⁸ The types of security interest recognised under English law are pledge, mortgage, contractual lien and equitable charge. See Benjamin, *Interests in Securities* (2000), pp.97–105. See also *Re Cosslett (Contractors) Ltd* [1998] Ch. 495; [1998] 2 W.L.R. 131; [1997] B.C.C. 724 CA (Civ Div).

⁹ A property or security could be either tangible or intangible; however, interests in securities are intangible. See Benjamin, *Interests in Securities* (2000), p.36.

¹⁰ Benjamin, *Interests in Securities* (2000), pp.33–34.

¹¹ B. Garner, *Black's Law Dictionary*, 10th edn (London: Thomson Reuters, 2014).

¹² Alan Schwartz, "Security Interests and Bankruptcy Priorities: A Review of Current Theories" (1981) 10(1) *Journal of Legal Studies* 1, 7.

property will only be allowed if the security interest was perfected¹³ according to the legal regime of the applicable jurisdiction.

Perfection of security interest

While an unsecured basic loan transaction encompasses an exchange of money from the creditor in return for a promise of repayment from the debtor, a secured loan arrangement incorporates two further aspects. The first is the creation of a security interest in favour of the creditor, making it easier for the creditor to collect on the debt if the debtor defaults or refuses to repay the debt obligation. The use of collateral also provides a creditor with additional reassurances that the debtor would repay in order to avoid the loss of that asset due to confiscation; it allows the creditor to avoid judicial and other available legal interventions to recover the debt, and reduces the extra burden and cost that would be associated with the verification of a borrower's financial status.¹⁴

The second aspect is the public declaration of an interest in the asset of the debtor. This provides the secured lender with priority to the proceeds of the asset¹⁵ over other creditors.¹⁶ Moreover, a public declaration also reduces the creation of false wealth that could jeopardise the financial stability of individual lenders, including trust between the financial system and third-party creditors.¹⁷

Furthermore, for a security interest to be created and perfected, there are three requirements that should be satisfied: a security agreement must exist between the debtor and the creditor, the property must be owned by the debtor, and the creditor must provide value to the debtor.¹⁸

When a security interest is perfected, it provides priority, in the event of bankruptcy,¹⁹ over unperfected interests and over subsequent perfection of interest while the previous perfection remains valid. This is the basic idea behind insolvency law: it promotes the equal treatment of creditors under the *pari passu* distribution of obtainable collateral, while an unperfected security interest only provides priority over the debtor and not necessarily over other creditors.²⁰

With the completion of a perfected security interest in collateral,²¹ a creditor would be more financially secure and able to extend credit to borrowers through various mechanisms which would lead to the development of the financial market.

The contributions of security interest to the development of financial markets

Vital to the evolution of a financial market are mechanisms that manage risks—including security interest which is among the primary determinants of a financial market's depth.²² In the advancement of secured transactions, it was widely held that in order for the creditor to obtain security in collateral to assume the corresponding risk of entering into a lending transaction, the actual transfer of the property to the creditor was required.²³ The legally held opinion was that the rights to the underlying asset, which is serving as the collateral, were tied to the possession of that asset²⁴; a reality which remains for many developing countries. This dependence on possession of personal property was well established by the turn of the 20th century,²⁵ but was eventually relaxed in more developed states as the need for credit enlarged, resulting in the development of, and subsequent challenges²⁶ to, different personal property security laws,²⁷ as will be explored shortly.

This perspective on the possession of collateral limits the use of the property in question which would be of concern primarily to a corporation which may need that asset in order to conduct its operations.²⁸ This is in the case where creditors maintain a preference for secured lending to be attached to real estate over moveable properties, leading to higher borrowing costs and reducing the potential of an economy to expand than would have been possible had this not been the case.²⁹ This situation remains a challenge in many developing countries, further limiting the growth of their respective financial sectors and impacting the development of their economies and the state of welfare of their citizens.³⁰

The disparity between developed countries which use collateral lending arrangements (about 70% in the case of the US) compared to developing countries (such as

¹³ P. Holden and H. Howell, "Enhancing Access to Finance in the Caribbean" (Inter-American Development Bank, October 2009), p.18 available at: <http://publications.iadb.org/handle/11319/4485?locale-attribute=en> [Accessed 30 January 2017].

¹⁴ McCormack, "The essence and importance of security" (2009).

¹⁵ Levie, "Security Interest in Chattel Paper" (1969) 78 Yale L.J. 935, 955–962.

¹⁶ Levie, "Security Interest in Chattel Paper" (1969) 78 Yale L.J. 935, 942–955; Picker, Baird and Jackson, *Security Interest in Personal Property* (2002), pp.22–27.

¹⁷ Boeck and Laryea, "Development of Standards for Secured Transactions and Enforcement of Claims" (2003), p.7.

¹⁸ Picker, Baird and Jackson, *Security Interest in Personal Property* (2002), pp.25–26.

¹⁹ Holden and Howell, "Enhancing Access to Finance in the Caribbean" (2009), p.31.

²⁰ Garner, *Black's Law Dictionary* (2014).

²¹ Security interest may provide property rights but they are not considered security. Benjamin, *Interests in Securities* (2000), p.324.

²² Holden and Howell, "Enhancing Access to Finance in the Caribbean" (2009), pp.18, 25.

²³ Section 9–203 of the Uniform Commercial Code still allows for this transfer. Picker, Baird and Jackson, *Security Interest in Personal Property* (2002), pp.25–26.

²⁴ Grant Gilmore, *Security Interests in Real Property* (Boston: Little Brown and Company, 1965), Vol.1, pp.24, 200–203; Steven Harris and Charles Mooney Jr, "A Property-Based Theory of Security Interests: Taking Debtor's Choices Seriously" (1994) 80 *Virginia Law Review* 2021, 2022.

²⁵ Gilmore, *Security Interests in Real Property* (1965), Vol.1, pp.289–294.

²⁶ The challenges posed from various laws will not be addressed in this article, but this is recognised as an area that needs further exploration in order to possibly further develop the financial markets and its interaction with interest in securities.

²⁷ Gilmore, *Security Interests in Real Property* (1965), Vol.1, pp.24–25.

²⁸ Picker, Baird and Jackson, *Security Interest in Personal Property* (2002), p.25.

²⁹ Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), pp.32–35.

³⁰ Holden and Howell, "Enhancing Access to Finance in the Caribbean" (2009), pp.19–20.

Argentina and Bolivia with about 90% unsecured) due to absent or inadequate legal regimes, renders financial markets riskier and so hinders development.³¹

Consequently, it became more appropriate to create a security interest in real estate for personal loans, and more practical to consider the inclusion of movable assets when creating a security interest for a corporation. In a modern business environment, it would have been problematic and counterproductive if a corporation was not able to retain access to and utilise those assets to maximise its operations.³² However, the ultimate determinants of which asset type to favour, in the case of a corporation, are: the timeframe of its financing needs, whether short-term or long-term, and the characteristics of the available collateral which indicate its suitability to create a lien in favour of the creditor.³³ Where these determinants are unsatisfactory, some corporations would still possibly maintain a preference for real-estate collateral as opposed to creating a security interest in a movable property and the alternative could be valid as well.

This led to the emergence of securities and security interest in the development of financial markets under both a common legal structure and a civil legal structure.³⁴ However, the importance of the development of these legal frameworks across the world was that the law maintained some element of possession through the perfection of security interest in the property.³⁵ Under both the common and civil legal structures, the development allowed for borrowing on a corporation's current³⁶ and future assets³⁷ which enhanced its ability to access funds from the market.³⁸ Additionally, it is worth mentioning that the development of a security interest in collateral was partly shaped by market forces with its influence on the legislative structure, which developed in accordance to the preferential demands of market participants.³⁹

Although market forces have a great level of influence on a financial market, regulators and policymakers need to promote the creation of security interest laws that are as simple as possible if they are to continue serving or

enhancing the development of financial markets. These laws should promote uniformity, simplicity, transparency, predictability and enforceability if they are to be widely utilised and harness the intended benefits attributable to security interest laws.⁴⁰

Legal security rights developments allowed for the promotion of an attractive form of reassurance for creditors⁴¹ with an equally beneficial result: access to cheaper capital for debtors.⁴² Furthermore, it may be argued that it is in the best interest of borrowers to fulfil their repayment obligation in order to ensure their future access to the financial market for additional capital needs that may arise. Hence, this self-preservation economic characteristic benefits the economy and provides the backdrop for implementing the legislative framework that promotes security interest, as it is considered an economic benefit to all participants to support these measures.⁴³

The ability to provide secured lending encouraged lenders to extend higher volumes of monies, given that this arrangement provides a greater level of protection than would have been the case under a less protective structure for creditors.⁴⁴ Such interplays among debtors and creditors contributed to an upsurge of economic activity and economic development as a result of the growth in the financial market.⁴⁵

A more recent development over the last few decades resulted from trading. As more capital was needed to meet liquidity requirements, corporations accessed cheaper capital by utilising receivables to create a security interest which was then sold to investors. A security interest can only be created over a property and not an obligation. Accounts receivables may be used as collateral since they are recognised as future property of the borrower.

Furthermore, the ability to create a security interest in a property revolutionised the financial sector's development globally as borrowers could now seek credit from international creditors.⁴⁶ This was aided by the financial innovation of intangible assets as service-oriented industries began to complement manufacturing industries worldwide. This would have

³¹ Heywood Fleisig, "Secured Transactions: The Power of Collateral" [1996] *Finance & Development* 44.

³² Empirical studies undertaken by the office of the Private Sector Development of the World Bank describes the limitations of immovable assets in Latin America compared to the practice of creating security interest in movable assets in North America. See Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), pp.259–260, 307–309. See also Boeck and Laryea, "Development of Standards for Secured Transactions and Enforcement of Claims" (2003), p.3.

³³ Schwartz, "Security Interests and Bankruptcy Priorities: A Review of Current Theories" (1981) 10(1) *Journal of Legal Studies* 1, 4.

³⁴ Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), p.2.

³⁵ Economic value from security interest is derived from the underlying security or asset that is represented in the transaction.

³⁶ Grant Gilmore, *Security Interests in Real Property* (Boston: Little Brown and Company, 1965), Vol.2, p.873.

³⁷ Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), pp.2–3, 150–152.

³⁸ Schwartz, "Security Interests and Bankruptcy Priorities: A Review of Current Theories" (1981) 10(1) *Journal of Legal Studies* 1, 2.

³⁹ Rapaczynski, "The Roles of the State and the Market in Establishing Property Rights" (1996) 10(2) *Journal of Economic Perspectives* 87.

⁴⁰ Boeck and Laryea, "Development of Standards for Secured Transactions and Enforcement of Claims" (2003), pp.2–4.

⁴¹ It is argued that the disadvantages of an unsecured creditor or, on the contrary, the benefit that could potentially be derived from having security, depend on other factors. Their arguments are that if a debtor enters into a secured transaction with another creditor, it may prejudice an unsecured creditor's ability to recover his monies from the collateral of the debtor. While if a debtor enters into secured transactions with more than one creditor, it can possibly negatively influence the amount of recoverable funds from that debtor's assets. However, one cannot deny the prevailing practice that secured lending benefits the creditor. See Harris and Mooney Jr, "A Property-based Theory of Security Interests: Taking Debtors' Choices Seriously" (1994) 80 *Virginia Law Review* 2021, 2028–2037.

⁴² Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), pp.24–25, 144; Holden and Howell, "Enhancing Access to Finance in the Caribbean" (2009), p.19.

⁴³ Rapaczynski, "The Roles of the State and the Market in Establishing Property Rights" (1996) 10(2) *Journal of Economic Perspectives* 87, 90–91, 101–102.

⁴⁴ Even though developments in private law have resulted in better protection for creditors, there remain challenges that could be further addressed through a unified model of substantive law. These would need to be addressed for even further development of a safer environment to promote trade via security interest and the financial market. See Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), pp.49–53. See also International Monetary Fund (IMF), *India: Financial System Stability Assessment Update* (IMF, 2013), Country Report No.13/8 available at: <http://www.imf.org/external/pubs/ft/scr/2013/cr1308.pdf> [Accessed 30 January 2017].

⁴⁵ Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), p.2.

⁴⁶ Benjamin, *Interests in Securities* (2000), p.37.

been more challenging in the absence of security interests in properties, as creditors would be unwilling to extend credit to borrowers in foreign jurisdictions if its legal protection required that the collateral had to be possessed by the creditor to guarantee security.⁴⁷ This financial innovation caused the security interest in assets to become more complex with the availability of capital markets, allowing capital to be raised through the issuance of various types of securities.

The ability to generate capital via a security interest offered through bonds and similar instruments⁴⁸ became more attractive with the creation of securitisation,⁴⁹ where assets from a single or multiple corporation(s) could be packaged and sold to investors with the utilisation of special purpose vehicles.⁵⁰ The special purpose vehicle would then pay off investors from the future cash flows that it managed without reflecting the payments on the books of the corporations. This allowed corporations to achieve reductions in financing costs, diversification of funding sources and so manage their risks.⁵¹

A crucial characteristic of securitisation is the potential it creates for small investors to invest in financial markets that they would not have been able to invest in on their own. These investments are made through institutional investors, such as pension funds or other financial intermediaries, who invest collective funds in various securitised products in order to generate a profit and contribute to the efficiency of the financial markets.⁵² However, an undesired but unavoidable aspect of this process is that it exposes investors to risks inherent in those securitised products as a result of the asymmetry of information that is present in any transaction, and which is more profound in financial market transactions as was evident in the recent financial crisis which started in 2007. This article will not explore the financial crisis but rather makes the case that, even in the face of the numerous benefits of security interest to the development of financial markets, there are constant challenges that need to be addressed by policymakers in order to strengthen this system and promote its continued development.

Conclusion/further areas for consideration

Recognising that the relationship between security interest and the development of financial markets needs to be explored further, given the interplays of various factors that contribute to the development of a financial market, this composition is limited in its present form due to various imposed factors.

However, an important area that needs to be further developed is the legislation and its framework in order to promote the use of security interest, especially in the case of developing countries,⁵³ which impacts on the development of the global financial markets.

An aspect that could be given consideration is whether a unitary or a multiple security interest framework is better able to promote financial development. The unitary method—as employed in North America—allows for a simplified, yet comprehensive, registration process for security interest, while the general European method is more diversified.⁵⁴ The decision then is dependent on which direction policymakers believe would produce a stronger growing financial market through the most efficient utilisation of the legal mechanism of security interest in properties.

The North American method is argued to benefit the creditor more than the debtor and the debtor's other creditors. This is the result as the initial creditor has the option, if allowed, to claim all the assets of the debtor,⁵⁵ while the European's diversified system offers more protection to the debtors.⁵⁶ Consequently, policymakers need to remain cognisant of maintaining a balance that would promote growth through access to cheaper capital which is the preference of any borrower and, more so, for a corporation whose objective is the maximisation of its profits. This consideration would aid the expansion of economies through the development of financial markets with a legal framework for promoting security interests which is premised on efficient credit distribution, and an effective predictable system to secure credit claims on debtors.⁵⁷

Research has shown that some common impediments to the utilisation of moveable properties, and consequently the creation of security interests in that type of collateral, are prevalent in developing countries. The most prevalent factors are the creation, perfection and enforcement of security interests.⁵⁸ It follows, then, that countries with

⁴⁷ This concept has existed for over 1,500 years when the Romans developed the law of hypotheca which is a form of security interest that resulted from the non-possessory pledge from the debtor over present and future assets. See Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), pp.3, 53. See also Boeck and Laryea, "Development of Standards for Secured Transactions and Enforcement of Claims" (2003), p.4.

⁴⁸ Although a security interest can only be created over a property and not an obligation, there is an argument that securities are neither. See Eva Micheler, "The Legal Nature of Securities: Inspirations from Comparative Law" (1 October 2009), SSRN available at: <http://ssrn.com/abstract=1481427> [Accessed 30 January 2017].

⁴⁹ Douglas Baird, "Security Interest Reconsidered" (1994) 80 *University of Virginia Law Review* 2249.

⁵⁰ Benjamin, *Interests in Securities* (2000), pp.281–299.

⁵¹ Frank Fabozzi and Vinod Kothari, "Securitization: The Tool of Financial Transformation", Yale ICF Working Paper No.07–07, SSRN available at: <http://ssrn.com/abstract=997079> [accessed 30 January 2017].

⁵² Fabozzi and Kothari, "Securitization", Yale ICF Working Paper No.07–07.

⁵³ Fleisig, "Secured Transactions: The Power of Collateral" [1996] *Finance & Development* 44.

⁵⁴ Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), pp.6–7; Benjamin, *Interests in Securities* (2000), p.87.

⁵⁵ Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), pp.6–7.

⁵⁶ Norton and Andenas, *Emerging Financial Markets and Secured Transactions* (1998), p.13.

⁵⁷ Boeck and Laryea, "Development of Standards for Secured Transactions and Enforcement of Claims" (2003), p.1.

⁵⁸ Fleisig, "Secured Transactions: The Power of Collateral" [1996] *Finance & Development* 44, 44–45; Jacob Yaron and McDonald Benjamin, "Developing Rural Financial Markets" [1997] *Finance & Development* 40; IMF, *India: Financial System Stability Assessment Update* (2013), Country Report No.13/8.

those security interest inhibitions associated with their legal framework are not able to realise the full benefit of the financial markets' ability to transfer funds from savers to investors and would do well to address those deficiencies to assist the development of the financial market and economy.

In addition to the development of the legislative framework, added attention needs to be given to the collateral that forms the basis of securitisation upon which security interests are created. This was found lacking during the recent financial crisis. While it may not have limited the development of the financial markets, the

inadequacy of the collateral values used in the securitisation process was underestimated and, among other factors, contributed to the widespread failure of financial markets.⁵⁹ Hence, the financial system developed but on a poorly conceived foundation which would eventually succumb to a financial market's efficiency mechanisms.

The above suggestions highlight areas that need to be strengthened where they relate to security interests in order to further aid proper financial market development both in developing countries and the wider global system.

⁵⁹ Jacques de Larosière, *The High-level Group on Financial Supervision in the EU* (The de Larosière Group, 25 February 2009), pp.7–9 available at: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf [Accessed 2 February 2017]; The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (25 February 2011), pp.42–51 available at: <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> [Accessed 2 February 2017].