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PROGRAM ON ESCAPING THE MIDDLE-INCOME TRAP: CHAINS FOR CHANGE

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POLICY BRIEF

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Movable collateral and partnerships in value chains

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Philippine President Rodrigo Duterte signed into law Republic Act No. 11057 or the Personal Property Security Act on 17 August 2018. The law intends to strengthen the legal framework for secured transactions in the Philippines through the creation of a national electronic registry for movable assets and the enforcement of security interests in personal properties. The objective is to entice financial institutions to lend to micro, small, and medium enterprises (MSMEs) through the setting up of a registry of personal and movable assets. It hopes to incentivize banks to consider other assets aside from land or real estate as the favored collateral. The national electronic registry, which will be incorporated in the Land Registration Authority (LRA), will include accounts receivables, bank accounts, inventory, equipment, vehicles, agricultural products, and intellectual property rights.

This policy brief discusses the salient features of the Personal Property Security Act and how it could improve the smallholders' access to formal agriculture credit. It also covers the key findings of the University of the Philippines Center for Integrative and Development Studies' (UP CIDS) Program on Escaping the Middle Income Trap: Chains for Change (EMIT C4C) from its action research on Jollibee Group Foundation's Farmer Entrepreneurship Program (FEP)[4] and other value chains.[5] Based on the FEP and other models, smallholders obtain formal financing (mostly from microfinance institutions or MFIs) because of partnerships that filled institutional voids (e.g., farmers' lack of or inadequate access to farm technology, agriculture extension, and business development services, their lack of access to corporate buyers, and their lack of organization leading to difficulties in reaching scale). In the models, the partners created the enabling environment for inclusive value chains. They used 'interlinked inclusive financing'—the bundling of production credit with the marketing of products—to enable access to and repayment of agricultural credit. Interlinked inclusive financing, in this regard, served the purpose of a collateral substitute.

The lessons from the FEP and other inclusive value chain models show that having movable (e.g., registration papers of vehicles) and immovable (e.g., farm land titles) collateral might be helpful in unlocking credit to the smallholders and value chains. However, the reform needs to be

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[4] EMIT C4C conducted fieldwork in (a) San Jose City, Nueva Ecija to interview the members of the Kalasag Farmers Producers Cooperative, the Local Government of San Jose City, Alalay sa Kaunlaran Inc., and other stakeholders, and in (b) Cebu to interview the farmer clusters in Sudlon II and Dalaguete, the officials of Lamac Multipurpose Cooperative, the Local Government of Cebu City, and other stakeholders.

[5] It will also include other models that were studied by the EMIT C4C program, such as the SKK Rice Processing Center of PinoyME Foundation and the Caritas Diocese of Libmanan, as well as the corn processing effort of Zamboanga Grains, Inc.

complemented with partnerships to be able to offer a complete bundle of interventions to farmers.[6] Otherwise, having acceptable collateral might result in financial inclusion that will eventually lead to a debt trap because of the enormity of institutional voids in smallholder agriculture.[7]

The need for formal agriculture credit

The Agricultural Credit Policy Council (ACPC) estimates the credit gap at Php 367 billion in 2014. This refers to the difference between the credit requirements of the priority commodities of the Department of Agriculture (DA) in 2014 and the financing supplied by banks in the same year. This gap also covers the credit needs of smallholders who found it difficult to borrow from financial institutions. Table 1 below shows that the total amount of agricultural loans released by banks in 2014 amounted to Php 158.3 billion pesos. This represents only a third of the total agricultural loans needed by the agriculture sector.

TABLE 1 Agriculture credit gap, 2014 estimates (in Php billion)

Major commodity	Credit Requirement	Supplied by Banks	Credit Gap
Rice and corn	226.7	56.1	170.6
Coconut	78.3	6.1	72.2
Sugarcane	29.8	14.3	15.5
HVCC*	80.3	37.7	42.7
Livestock and poultry	88.1	37.6	50.5
Fisheries	21.7	6.5	15.2
Total	**524.9**	**158.3**	**366.6**

Source: DA Agricultural Credit Policy Council 2016

* HVCC or high-value crops and commodities include abaca, cassava, rubber, mango, coffee, banana, durian, lanzones, mangosteen, oil palm and other vegetables like cabbage, onion, carrot, tomato, eggplant, white potato, cauliflower, broccoli, and habitchuelas.

The smallholders' lack of or insufficient access to formal credit is a major constraint because they need financing for agricultural production and household needs, such as purchase of inputs, payment for farm labor, rental of equipment, transport of goods to the market, making ends meet during low seasons (e.g., crop gestation), investments in education and health, and emergency situations (Geron et al. 2016). Without access to formal finance, smallholders often resort to informal financial providers who require higher interest rates. Informal credit markets therefore remain an important source of financing for smallholders (although their reach is waning). A study by the Asian Development Bank (ADB) showed that rural informal credit markets in Asia can still be considered as an important sector, covering 40 to 70 percent of total rural credit sources from different countries.

For banks, lending to smallholders is challenging.[8] The Bangko Sentral ng Pilipinas (2017) itemizes five challenges:

(1) *Cost:* High transaction costs for financial institutions in lending to farmers due to geographical limitations, long funding cycles, large upfront costs

(2) *Credit history:* Financial institutions have limited knowledge about the credit history of borrowers, limited available documents

(3) *Collateral:* Lack of acceptable guarantees (i.e., land titles, proof of ownership of assets); weak institutions for protecting property rights

(4) *Contention:* Perception that poor cannot pay and are considered as high risk

(5) *Channel:* lack of infrastructure for assessment, disbursements, loan collections, etc.

[6] For financial institutions, there is no substitute for relationships in value chains, knowing the character of borrowers, and solid assessment of farming households' cash flow.

[7] In the value chains that were studied, improving access to credit first or as a stand-alone initiative led to farmers' having improved access to formal financing. However, without access to major buyers like Jollibee Foods Corporation, supermarkets, etc., capacity building, and organizing of smallholders, access to credit resulted in a debt trap for some of the farmers. They obtained loans, utilized it to improve their yield and other household requirements, but during harvest, they again sold—individually—their products to spot markets that did not give a premium on better quality and quantity of produce.

[8] The ACPC also noted the following constraints to smallholder lending: (a) weak capacity and lack of viable projects, (b) high risk and cost of lending, (c) lack of innovative loan products, (d) limited information for lenders and borrowers, and (e) farmers are discouraged with borrowing from financial institutions.

Insufficient collateral is among the top reasons for the difficulty in accessing formal credit. However, the International Finance Corporation (2010) underscores that the unavailability of collateral is often not the problem; rather, it is the inability to utilize valuable assets as collateral.

Interlinked inclusive financing

EMIT C4C conducted an action research on key value chains. The smallholders recall that prior to the Farmer Entrepreneurship Program, there were numerous occasions when they needed to pawn their assets (e.g., land, jewelry, registration papers of their vehicles, and farm animals) to informal lenders to obtain production capital and address emergencies and investment requisites.

With the FEP, formal financing flowed to the farmers through the use of interlinked transactions. Individual smallholders were able to borrow in-kind and in-cash production loans from their cooperatives (e.g., Kalasag Farmers Producers Cooperative and Lamac Multipurpose Cooperative) on condition that they will sell around 60% of their onions or assorted vegetables to their cooperatives.

Esguerra (1993) defines an interlinked transaction as a contract where two parties trade in at least two markets on the condition that the terms of all the trades are jointly determined. In his study of informal trader-lenders in Central Luzon, Esguerra noted that interlinked contracts performed the function of collateral substitutes for being able to screen borrowers and ensure repayment. As a screening mechanism, interlinked transactions are a means for determining farmers' willingness and capacity to engage in interlinked agreements by their decision to borrow and their repeat involvement. As an enforcement mechanism, interlinked transactions allow trader-lenders to have first claim on the proceeds of the sale and thus, they are in a position to directly collect loan payment. For Fabella (1992), the smallholders' incentive to repay their loans in-kind is higher compared to cash-for-cash transaction when the price of products is uncertain and when farmers are risk-averse.

Unlike the interlinked transaction of trader-lenders, the interlinked inclusive financing in the FEP was improved by formal and informal mechanisms. First, there was the pre-commitment of the Jollibee Foods Corporation (JFC) to purchase from the smallholders. Second, there was also the commitment of program partners to help the smallholders in terms of (a) bridging them to JFC and other major buyers, (b) building their capacity on the agro-enterprise approach, (c) organizing them, and (d) linking them to financial institutions. Third, the program partners concretized their commitment through shouldering social investment costs or expenses meant to improve the human capital of farmers and other stakeholders.

The mechanisms are described by smallholders as a "complete recipe" or a complete bundle of interventions that enabled them to sell directly to JFC and other major buyers based on the agreed upon quantity, quality, and timing of delivery. Without the complete bundle, the farmers imagined that it would have been difficult for them to diversify the buyers of their products and they would have remained locked in to their *suki* (favored buyer), who are usually the trader-lenders and the spot buyers.

The interventions and the commitment of partners incentivized the Alalay sa Kaunlaran Inc. (ASKI), the microfinance institution that funded the interlinked transaction of the Kalasag farmers, to lend to the farmers. In 2008 when the FEP was being piloted, ASKI was hesitant to lend to the newly-formed Kalasag farmers. The smallholders had no financial records and no collateral. In fact, there were loan defaults in the villages where the FEP was piloted (Barangays Kaliwanagan and San Jose).

ASKI banked on the reputation and commitment of the Jollibee Group Foundation, Catholic Relief Services, National Livelihood Development Corporation, and the local government of San Jose City. It loaned money to the Kalasag Farmers Producers Cooperative to be used for production lending and working capital (so the cooperative can purchase the deliveries of farmer-members). ASKI (and eventually the other MFIs and cooperatives that provided financing to various FEP farmers) and other partners filled the institutional voids. Their contributions enabled the exchange between the smallholders and the major buyers.

How the Personal Property Security Act can complement the FEP and other inclusive value chain models

Some of the important features of the Personal Property Security Act are as follows:

(1) A security interest (a property right in collateral that secures payment or other performance of an obligation) is created though a security agreement, which should be contained in a written contract and may provide for the creation of a security interest in a future property.

(2) A security interest in personal property shall extend to its identifiable or traceable proceeds including proceeds in the form of funds credited to a deposit account or money that are comingled with other funds or money. But the security interest in comingled funds or money shall be limited to the amount of the proceeds immediately before they were comingled.

(3) A security interest may be perfected by registration of a notice with the Registry, possession of the collateral by the secured creditor, and control of investment property and deposit account.

(4) Prioritization for perfecting security interest in deposit accounts, electronic securities, instruments, and negotiable documents.

(5) Establishment of an electronic registry to be established and administered by the LRA. The information shall be considered as a public record and any person may search the notices in the registry.

The Philippines has a legal environment for secured transactions including the Chattel Mortgage Law and a document-based movable collateral registry operated by the Register of Deeds. Republic Act No. 9700 or the Comprehensive Agrarian Reform Program Extension with Reforms also mandates the use of expected harvest and marketing agreements as collateral that can be used by agrarian reform beneficiaries. The current policy regime also recognizes different movable assets as collateral for loan purposes (e.g., motor vehicles, standing crops like rice, sugarcane, and other agri-aqua commodities, equipment) but, with the exception of motor vehicles, movable assets are not the banks' preferred collateral in lending money to smallholders.

The passage of the Personal Property Security Act is expected to improve lending of financial institutions to micro, small and medium enterprises including agricultural smallholders. In countries with a similar Secured Transactions Law, critical features made the reform effective: (a) creditors are prioritized in cases of loan defaults, (b) removing priority on tax-liens so that tax authorities must register their claims with other secured creditors, (c) parallel Law on Auctions that ensured timely sale of collateral, and (d) improved policy environment for enforcement of security (IFC 2010).[9] It is recommended that these features are strengthened in the crafting of the Implementing Rules and Regulations (IRR) or in developing future policies.

The Personal Property Security Act can complement the partnerships including interlinked inclusive financing mechanisms in value chains. It can also complement the efforts of financing institutions to know the character of farmer borrowers and to assess their households' cash flow.

With correct incentives, banks might be enticed to lend to smallholders and their organizations, help fill other institutional voids, and contribute to social investment costs. When banks are involved in inclusive and competitive value chains like the FEP, there could be better loan terms, such as lower interest rates for agriculture lending (e.g. purchase of equipment and machines) and for setting up off-farm or non-farm enterprises to diversify income from agriculture.[10]

[9] In countries where a similar Secured Transactions Law was passed, credit to the private sector as percentage of the gross domestic product (GDP) increased. Where security interests are perfected and there is a priority system for creditors in cases of loan defaults, private sector loans to GDP averages 60%, compared to only 30% to 32% on average for countries without similar credit protection. Also, a secured transactions system contributed to the decrease in the cost of credit. Borrowers with movable and immovable collateral benefit from increased access to credit, longer repayment period, and lower interest rates.

[10] In the value chain model of the FEP, the farmer's groups have movable collaterals like expected harvest, marketing agreements, vehicles, and other assets that could interest rural and commercial banks.

However, when movable collateral entices financial institutions and they start lending to smallholders without the other ingredients in the "complete recipe," financial inclusion might result in a debt trap. Caution should be made in ensuring that institutional voids are analyzed and addressed to enable inclusive and competitive value chains. This means assessing the end-to-end of the value chain (pre-production until consumption) to see if minimum requirements are in place for smallholders to be able to deliver to other buyers aside from spot markets and traders. If there are huge gaps or institutional voids that are not addressed, formal financial inclusion—incentivized by the new policy on movable collateral—might result in deeper indebtedness of smallholders.

Conclusion

The newly-legislated Personal Property Security Act could potentially improve the access to credit of smallholders. Banks that could provide better credit terms might be enticed by the law. However, improved access to credit alone is not sufficient. In the FEP model of the Kalasag farmers and the smallholders assisted by Lamac Multipurpose Cooperative, access to credit is one of the elements in a bundle that likewise includes access to major buyers (so the farmers could have other buyers aside from trader-lenders and spot markets) and farmers' organizing and capability building. There might be other necessary conditions that are also needed depending on the crop, commodity, location, and stakeholders of value chains.

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