Penn State International Law Review

Volume 27
Number 3 *Penn State International Law Review*

Article 5

5-1-2009

Legal Efficiency for Secured Transactions Reform: Bridging the Gap Between Economic Analysis and Legal Reasoning

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INTRODUCTION

The case for the importance of law and institutions to boost investment and access to credit does not have to be made. Other chapters in this article have unambiguously demonstrated that secured transactions and creditors' rights are among the most influential measures. This need was acknowledged by the countries of Central and Eastern Europe and the former Soviet Union from the very beginning of the transition process. Since 1990 a huge effort has been made to transform their legal regimes. From the moment communism had collapsed it was urgent to introduce the changes that were necessary to develop modern market economies. The laws and institutions relating to commercial transactions (such as the laws of contracts, companies, property and insolvency) were hopelessly inadequate and economic reform had to be accompanied by major programmes for legal reform. Never before did so many legal systems have to change so much and in such a short period of time.

The European Bank for Reconstruction and Development (EBRD or the Bank) has engaged in many aspects of legal reform in the region. Its involvement in secured transactions reform began in 1992 and has continued every since. The objective of the Bank is to encourage countries to modernise their secured transactions laws[1] and it offers

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1. In this article we use the term "secured transactions" to embrace all transactions such as pledge and mortgage where the principal aim is to give security, not in the more limited sense (as given in the USA under article 9, Uniform Commercial Code—Secured Transactions) of relating only to security over movables.

assistance at all stages of the reform process to achieve an effective legal framework for secured transactions, building a consensus for those reforms and then assisting in the preparation of necessary legislation and the implementation of the law. To a large extent, this call has been heard in Central and Eastern Europe. When the EBRD Secured Transactions Regional Survey was published in 1999[2] most countries in the region had undertaken reform on this part of their legal framework. By 2004, all of the countries had done so. Yet, the assessment of their regimes is not consistently positive. In fact, in some cases, despite what seems to have been considerable efforts, users are still denouncing restrictions or problems in the legal and institutional framework for secured transactions. Why?

In this article we look at two questions that constantly arise and that we have been able to observe while engaged in this reform work:

1. How do you define the precise objectives of a law reform proposal and to ensure that they are adhered to throughout the reform process;

2. How do you assess whether a law reform is successful?

To address the first question we will draw in particular on our experiences of what happens in the transition countries of central and eastern Europe when a secured transactions law is proposed. We do not have the space for detailed case studies and we seek rather to give a broad overview of how the reform process works (or fails to work). Every reform project has its own list of successes and failures, and there is always scope for presenting critical analyses of specific cases. However when one takes the time to look back at what has been achieved it is more constructive to do so in a sense of learning and building on past experience. Our intention is not to draw attention to past failings and mistakes but to look at the lessons that can be learnt from the experiences of the past fifteen years. On the second question, surprisingly little has been done to develop methods for assessing whether a law reform is successful—or, to use other words, what makes a secured transactions system "legally efficient." We will describe the concept of "legal efficiency" and explain how we use that as the basis both for establishing the objectives of reform and for evaluating the result.

2. *See* EUR. BANK FOR RECONSTRUCTION AND DEV., LAW IN TRANSITION: SECURED TRANSACTIONS (2000), *available at* http://www.ebrd.com/pubs/legal/lit002.htm.

Of course, both questions are linked. During the first part of this article we will often refer to "efficient" laws and in the second part we will put forward the criteria that may be used to determine what makes a law "efficient." The primary reason for introducing a secured transactions law is economic. Secured transactions are encouraged because of the economic benefits that can be derived from them and the law is needed first and foremost to enable those economic benefits to be maximised. In spite of all the progress in collateral reform in recent years there has been a failure to create a coherent and constructive connection between the economic and the legal fundamentals and it is this issue that we will try to address.

THE PROCESS OF LAW REFORM

The typical law reform can be divided into four stages:

a) consultation and decision to reform
b) designing and passing of legislation
c) establishing the necessary institutions and implementing mechanisms
d) bringing the law into force.

Although these stages are interdependent, it is our experience that as the process develops the focus tends to become hazy, with the objectives somehow becoming lost and the gap between the economic and the legal analysis widening, sometimes alarmingly.

Decision to Reform

There has to be agreement at a political level that a new law is needed.[3] In the case of secured transactions this is likely to be based on a belief that a modern legal framework will boost the availability of credit and investment. The decision to reform should be taken because of the perceived benefits to the economy. If a finance ministry agrees to include a secured transactions law in the legislative programme mainly in order to placate a persistent international financial institution or other external influential organisation, the reform will be off to a bad start. There is a need for a broad consensus on the reasons for introducing the reform and what it is aiming to achieve. The breadth and depth of the decision-making process will often be critical for the reform's subsequent phases.

3. This does not exclude that the reform initiative may have come initially from the users and other stakeholders before being relayed to the executive (typically the government) or the legislative (parliament).

Usually one ministry or other agency (e.g. Central Bank) will assume the task of developing the reform proposal. The approach at this stage can vary greatly. Sometimes it is limited to taking the necessary steps to obtain a government decision to adopt the proposal in principle and to put the requisite legislation on the parliamentary agenda. However, much more can be done to put the reform on the right track and to increase the chances of a successful outcome. As with any project, early preparation and management is likely to be well rewarded. An understanding is required of the issues involved in the reform, the options that will be faced and the possible broader implications of what is proposed. Providing information to and seeking support from other ministries and organisations who may be involved is more than just part of the normal political process: it greatly facilitates subsequent work on transforming the proposal into reality.

The Ministry of Justice and other sectors of the legal community may merit special attention. Legal conservatism and a protectionist attitude towards "legal traditions" can, if not appropriately managed, become major obstacles to successful reform. Also at this stage external support and technical assistance may be sought but it is essential to understand that this assistance is precisely only technical: it cannot substitute for what is primarily a policy and political decision.

The most important outcome of this stage should be a broad consensus on what is to be achieved and the reasons for wanting to do so. Our experience is that a spineless reform project is unlikely to get strengthened at a later stage. A strong consensus at the outset on *all* of the key aspects of the reform will provide a powerful force for subsequently surmounting the many difficulties that will inevitably arise as the reform proposal proceeds.

Designing and Passing Legislation

Law reform is not just about writing and adopting laws the other stages are equally important. The process of preparing the necessary legal texts and steering them through the adoption process is often a lengthy and complex task and if it is badly managed the whole reform may be jeopardised. The outcome of this stage should be a law or legal provision that enable the desired reform to be implemented efficiently. We look later at how "efficiency" can be gauged but here it is appropriate to look at some of the factors that may impede this stage of the law reform process.

Losing Sight of the Objective

The lead players for preparing the legislation will most often be lawyers because drafting laws is essentially a legal role. If the decision-making process has been well prepared, the economic objectives of the future law should be well analysed and presented. However that may not be enough to ensure that the legal drafting team fully understand the economic objectives and actively assess the draft they produce against economic criteria. The Ministry of Finance and Economic Affairs or the Central Bank, or any other "champion" of the reform, needs not only to remain involved but continually to monitor the drafts that are produced against the economic rationale for the reform. Players from the financial markets can usefully be consulted (see comments under market resistance below). Secured transactions may not be rocket science, but there are any number of details which, if not properly understood, could steer the reform off track. Without good management of the drafting process the law presented is likely to fare badly when assessed against the legal efficiency criteria that we discuss below.

Legal Conservatism

The drafting of legislation is a difficult skill to acquire which is not given to just any lawyer who is practised in drafting the legal documents required by his clients. It requires a deep understanding of the purpose of the law, an ability to visualise the effect that the draft law may have on the existing body of laws and, most importantly, a capacity to relate the law proposed to existing and future market practice. It is this capacity to perceive the way in which the law will support (or fail to support) market transactions that is especially important and also quite rare. It should be possible to develop the requisite qualities within the drafting team, but the same cannot necessarily be expected for other lawyers who are consulted or who express views on the draft. Lawyers from their very training are likely to view with suspicion any departure from existing legal rules. The protection of legal tradition and the integrity of the legal system is to be encouraged but they have to be balanced against the need of markets to move forward. Regrettably it happens all too frequently that lawyers who contribute to the legislative debate make little attempt to achieve that balance, and indeed often have little understanding of the economic objectives of the law.

Market Resistance

It sometimes comes as a surprise that resistance to the introduction of an efficient secured transactions law comes from the persons who

could be expected to derive the most benefit from it. Banks, lenders and other creditors who give input at the drafting stage will not always be favourably disposed to the reform, or to some of the features that are precisely designed to make it efficient. They may require some persuading that from their perspective the proposed changes will be preferable to the existing market practice. The lure of increased credit activity may be tempered by fears of increased competition and lower margins. The problem may be compounded if the persons giving input are not the managers who are capable of understanding the broad economic picture but representatives from the legal department who are more concerned at how to document a transaction than its justification in a wider context. Even bankers may not understand all the reasons underpinning the reform. In one country recently, provisions in the draft pledge law designed to facilitate taking security for syndicated loans were struck out because of opposition from bankers who did not understand what a syndicated loan was, or assumed that it was undesirable or unnecessary in the local market.

The solution however is not to restrict consultation, rather to adapt the way in which it is carried out. If economists, bankers and investors, especially those who have been exposed to modern market practices, are not given a guardian role in the reform at the drafting stage it will be all the more difficult to keep the implementation on track later. The fact that the banking sector in Central and Eastern Europe has seen a large strategic participation of foreign investors should facilitate the introduction of modern market practices. Paradoxically, because the domestic markets in many Western European countries have been protected from external influences and thus slow to introduce modern techniques, resistance can sometimes come from those foreign dominated banks who do not understand why the transition country should need a "modern" secured transactions law and prefer to see replicated the system they are used to in their home country.

Incompatibility of Technical Assistance and Foreign Input

In transition countries considerable technical support has been given for secured transactions law reform from national and supra-national providers of technical assistance (of which EBRD is one). Although much of that assistance has been efficient and has contributed to the success of reform, it has also to be admitted that the nature of the assistance and the way it is provided sometimes falls short of what could be expected. The role of the technical assistance provider is a delicate one. It is there to provide expertise, practical advice and guidance using experience of reforms elsewhere, and to ensure that the original

objectives of the reform decision drive the process. It can also bring additional resources that would not otherwise be available. Its role is to assist, not to dictate or impose.

We put forward a few guidelines for assistance providers:

1) The drafting should be done by local lawyers. The law will have to fit in to the existing legal framework and someone who is not from the jurisdiction, however knowledgeable, is ill-placed to draft it. It is also desirable that local lawyers acquire a full understanding of all the issues and accept responsibility for the draft. A home-grown product, as opposed to a foreign implant, will engender a sense of achievement and with that should come a greater commitment to defend it and to see it properly implemented over time. A very good example of this is found in Bulgaria, where the 1998 Pledge Law was developed by Bulgarian lawyers, who understood very well the objectives of the reform and are still actively following up on how the system is faring.

2) The temptation to import foreign law concepts should be resisted. In a civil law country you cannot, for example, introduce a trust by sleight of hand. It may take longer but the drafters have to understand fully each aspect of the result desired from the reform and then work out how they can be achieved in the context of their own legal tradition and institutions. Foreign examples will certainly be a source of inspiration but will also be a source of confusion and inefficiency if imported without adaptation and reconstruction in order to fit to the local environment. Perhaps the worst sin is when assistance providers produce a draft in their own language substantially based on their own law and then present a translation of that draft as the law to be adopted. This caricature of technical assistance has for the most part now disappeared in Central and Eastern Europe but unfortunately the negative effects can still be felt. In fairness to technical assistance providers, the fault does not always lie with them. In some instances, a ready-made product is what the developing country will request and expect to be given.

3) Some understanding of the local legal tradition is essential. Ideally the assistance provider will mobilise experts who speak the local language and be well versed in the local law and practice. In practice that will not often be feasible but the assistance provider needs as a minimum to acquire a basic understanding of the approach of the local law and practice. Without that he will operate under a severe handicap.

4) The approach should be dispassionate and impartial. Once again the underlying philosophy is to encourage and support the local ownership of the project. The assistance provider is there to help develop a consensus on the reform objectives which is compatible with the original rationale and then to ensure that those objectives are translated into the legal system with maximum efficiency. The issues need to be presented in a manner which is balanced and conducive to rational decision. One of the more difficult aspects of the international expert's work is to detach himself from his legal roots, to present legal issues objectively. Every lawyer is conditioned by his legal training and may tend sub-consciously to believe that his own law is superior but that has to be resisted. It is sad to witness how often well-meaning lawyers working on law reform in transition countries press for solutions based on their own law, when with a little objective analysis it can be seen that the solution proposed is not appropriate for the local context or that other routes may be just as valid.[4]

Once finalised the draft law will pass through the parliamentary process. At this stage the drafting team needs to be vigilant to ensure that the draft does not fall victim to the uncertainties and excesses of the political process. One of the greatest dangers is amendments made at this stage by politicians who have their own agenda which may have

4. When the secured transactions project was set up at EBRD in 1992 a policy was introduced that there should always be in the team at least one lawyer from a common law background and one from a civil law background. The transition countries are civil law based but much of modern financial practice is inspired by common law solutions. That policy has been conscientiously pursued ever since and it has certainly had a considerable influence on all of EBRD's work in this field. If you have to discuss and agree issues across legal boundaries in-house, you are that much better prepared to adopt an open-minded approach when working in a local jurisdiction.

little to do with the issues covered by the law. However if the draft has been well prepared, objectives are clear, consultation process wide, and the presentation is persuasive, the chances are that political battles will not interfere with the adoption of the law.

Establishing the Necessary Institutions

Institutions will be established to enable the new law to operate. In the case of a secured transactions law a registration or "notice filing" system is needed and viable and efficient procedures have to be established to enable the security to be enforced. Often at this stage the people involved will change. Drafting a law is high profile, even more so if it involves amending the Civil Code, and may attract considerable high level interest. Setting up a pledge register is definitely not sexy work and may be left to administrators and IT experts. If they do not have a proper grasp of why the register is being established and the implications its use will have on market practice, there is a risk that inefficiencies will be introduced through superfluous or inappropriate requirements. The instinctive approach of a registrar towards pledge registration may be quite different to that intended by the law. If he is not properly briefed on the purpose and aims of the law he may, for example, build a title registration system modelled on a land register, which would definitely not be an efficient way of publicising pledges.

Similarly enforcement procedures often lose sight of the fundamental objective in the context of secured transactions, which is of achieving a rapid sale of the assets given as security at a high price. There are many opportunities for creating overly bureaucratic public auction and other procedures, which provide "protections" which are of little benefit to the debtor or creditor who are party to the enforcement. The gap between the economic analysis which underlays the original reform decision and the mindset of those developing the register or the enforcement procedure is sometimes alarmingly wide, especially when those responsible for the initial reform initiative have moved on to other things and fail to ensure effective follow through.

Bringing the Law into Force

Once the new law enters into force the task of making the new regime work in practice is entrusted to market players, institutional administrators and, in the final count, judges. How it works will be determined, to a large extent, by how the new regime is explained, and the support and guidance that is given to those to whom it is entrusted. Lawyers and bankers may be happier with the old system they were familiar with and slow to realise, or fearful of, the scope the reform gives

for new deals. As with any new product the way it is introduced into the market may be just as important as the quality of the product itself. Often those active in the reform process will have moved on to the next task and there are few resources available to analyse whether all the effort bears fruit. A common problem is the lack of a good understanding of the new law by those who will apply it at the moment when it is most needed: the courts. Unfortunately, it is rare for the judiciary to be closely involved in developing the reform from the outset. The danger is that the courts may then not grasp the effect (or intended effect) of the law and interpret it in a narrow or limitative way.

Much can be done to assist at this stage: education and awareness programmes, dissemination of promotional and explanatory material, training programmes, pioneer transactions sponsored by IFIs, and monitoring of the way the law is working (or not working) in practice against what was intended. The idea that the reform will be perfectly applied first time is a myth, especially in the fragile and fast-changing environment of a transition country. Reform is a continuing and gradual process and after any major step is taken, such as the introduction of a new law, careful monitoring is necessary to identify problems and find solutions. Inevitably the legal implementation of a law will not always correspond to the underlying economic rationale. If discrepancies are addressed rapidly solutions can most often be found relatively simply. If they are left to develop there is a danger that they can eventually jeopardise the success of the reform. In Poland the pledge law when introduced in 1996 was a good example of a modern pledge law but, in contrast to neighbouring countries that introduced similar laws, it has failed to deliver the expected benefits precisely because of the way it has been implemented.[5]

In order to be effective, the nature and purpose of the monitoring and evaluating task has to be clearly understood. It is not a policing task aimed at disciplining those that do not behave as intended, nor is it a kind of audit to enable the external assistance provider to verify the success of the project. It is more in the nature of an active after-sales service designed to ensure that the new product works, that its users derive maximum benefit from it and that the economic benefits that were assumed from the reform indeed materialise. It requires encouragement and support from the reform's champion since it can only be successful when it is underwritten by a commitment to carry it through effectively. It also requires sound methodology and benchmarking, and this leads us

5. *See* EUR. BANK FOR RECONSTRUCTION AND DEV., THE IMPACT OF THE LEGAL FRAMEWORK ON THE SECURED CREDIT MARKET IN POLAND (2005), *available at* http://www.ebrd.com/country/sector/law/st/facts/nbpeng.pdf.

to the second part of this article—the question of how a reform's success can be assessed.

ASSESSING THE SUCCESS OF REFORM: THE CONCEPT OF LEGAL EFFICIENCY

The process of reform is not an easy one. It is hampered in particular by an often inadequate analysis of what the reform is aiming to achieve and a lack of clear directions to guide the work as it progresses. Government proposes a law on secured transactions in order to facilitate access to credit. A team of local and foreign experts help the government prepare the necessary legislation, which is duly passed. A different set of government employees and external contractors establish a register or notice filing system and a public auction procedure. Everyone has done their job, the reform is complete and yet, the result in terms of facilitating access to credit may fall well short of what was intended. Or, as is most often the case, nobody has a clear idea of what the result of the reform actually is. What is missing are the constant and well-defined goals which determine the direction of the process and ensure that it leads to the desired result.

A lawyer who is drafting a pledge law or an administrator who is setting up a pledge registration system needs to be given a clear picture of the end objective, not just as a technical description of the law or register, but also by way of indication of the ways in which it should actually facilitate access to credit. In this way he gains an understanding of the broader issues involved, including the economic function of the law, and will realise that the outside world will be judging the law or register with these in mind. In practice surprisingly often that is not the case.

In order to address this gap we use the concept of legal efficiency. What do we mean by "legal efficiency"? We use it as indicating the extent to which a law and the way it is used provides the benefits that it was intended to achieve. We look at the concept against the background of secured transactions law because we prefer to link it to our direct experience in transition countries, but we believe it is capable of much wider application.

As mentioned before, the prime purpose of a law regulating pledge or mortgage is economic, since the secured credit market has essentially an economic function, (whilst recognising that it may also have important social functions and consequences); and it is essentially facilitative since a secured credit market is not a necessity, it being possible for any jurisdiction to function without it. We work on the premise that the basic legal framework should be *conducive* to a flexible

market for secured credit. There are also social issues, for example relating to consumer credit and housing, but the driving force behind the introduction of a law on secured transactions is the benefits that it is expected to bring to the economy.

A relatively simple indicator of the success of a secured transactions law reform (or primary motive for undertaking the secured transactions law reform) would be the subsequent increase in the *volume* of secured lending. This is a crude and narrow indicator, inadequate by itself. The intended function of the secured credit market may be more than just to boost the amount of credit granted against security. It may also include, for example, opening up credit to new sectors of society, encouraging new housing construction, or allowing privately-funded infrastructure projects.

The intended function of a law has to be looked at in the context within which it is to operate. Its ramifications have to be considered not just in economic terms but in social and cultural terms as well. An appropriate balance has to be found between fulfilling the law's economic purpose and ensuring that the effects of the law are acceptable in context. The purpose of the reform needs to be carefully analysed and agreed at the outset, failing which the potential achievements of the law in terms of legal efficiency may be curtailed. It sometimes happens that the goals of the reform are not clearly defined, or that they are not perceived in the same way by all persons involved. That can be fatal to the subsequent implementation. Without well-defined and accepted goals there cease to be unambiguous criteria against which the reform can be assessed. The boat is sailing with no sense of direction and it is unlikely it will reach port safely.

Legal Efficiency Criteria

We analyse legal efficiency by looking at the degree to which the legal framework enables secured transactions:

a) first, to achieve their basic function and

b) secondly, to operate in a way which maximises economic benefit.

And, as shown in the table, we break the second criterion into five separate headings: simplicity, cost, speed, certainty and fit-to-context.

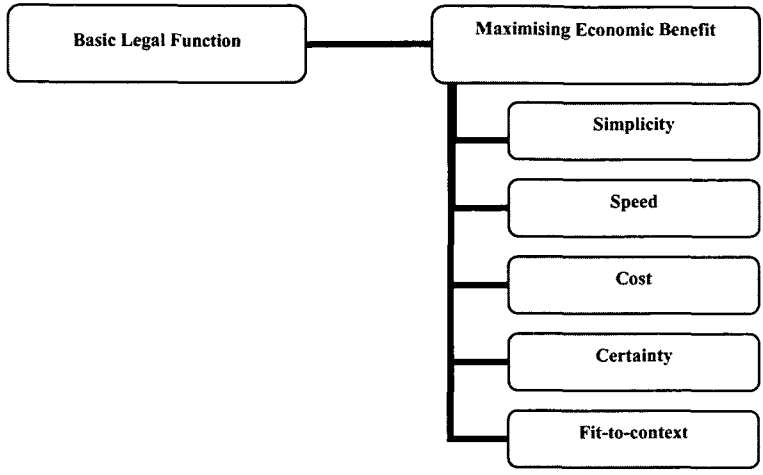

Table: Criteria for legal efficiency of secured transactions law

The basic legal function of a secured transactions law is to allow the creation of a security right over assets which, in the case of non-payment of a debt, entitles the creditor to have the assets realised and to have the proceeds applied towards satisfaction of his claim prior to claims of other creditors. If a secured transactions law only gives the creditor a personal right but no right in the assets, or if there is no right to enforcement, or no priority vis-à-vis other creditors, the law fails to achieve its basic legal function. An absolute priority for taxes and other state claims ahead of the secured creditor, or the right in insolvency of ordinary creditors to share in a portion of the proceeds, are more than inefficiencies in the secured transactions law, they are defects which prevent it from fully achieving its basic function. They may be intentional (a super-priority of the state usually is) but they reflect a compromise between two laws with conflicting purposes. Any such compromise inevitably inhibits the effective operation of the secured transactions law and introduces uncertainty into the minds of lenders.

If the legal framework for secured transactions is to operate in a way which ***maximises economic benefit,*** the system for creation and enforcement of pledge or mortgage should be simple, fast and inexpensive, there should be certainty as to what the law is and how it is applied, and it should function in a manner which fits to the local context.

Simplicity—Simple does not mean simplistic: it is necessary to strike a balance between simplicity and the sophistication required by the

market. In many countries complexities have developed and become entrenched over time as laws have been adapted to new circumstances, not because of the sophistication of these circumstances but rather from inherent limitations of the legal system. There exists in transition countries a huge opportunity to reduce down to the essential elements and to introduce laws which are directly adapted to modern market requirements. Part of simplicity comes from the lack of restrictions and barriers. If the law is to facilitate the use of secured credit it needs to provide a base which offers the necessary flexibility to adapt with the trends of the market.

Speed—For most aspects of the legal process, the less time it takes the more efficient it is. There are exceptions: a notice period or a cooling off period has to be of appropriate length, but for registration of a pledge or mortgage, for example, there can only be benefits if it takes only a few minutes rather a month, and a lender who knows that enforcement of the pledge or mortgage is likely to take several years will derive less comfort from his security.

Cost—Legal costs almost inevitably have an adverse impact on the economic benefit of a transaction. Delay, complexity and uncertainty all tend to add to costs so there is a close relation with the other aspects of legal efficiency. Some costs are, at least to an extent, within the control of the parties. Before taking legal advice on structuring a transaction the parties can assess the value of doing so. The cost of legal advice on a complicated transaction may be outweighed by the benefits, but the cost of legal advice incurred because of defects in the legal framework always reduces efficiency, as do fixed costs (for example registration, notary or court fees).

One does not have to be an economist to understand that if the legal procedures for creating and enforcing a pledge or mortgage are slow, expensive and complex, the cost of secured credit will be higher and the economic benefit of using pledge or mortgage reduced. There are however two other elements that need to be taken into account when assessing legal efficiency. They are sometimes overlooked by economists because they are more difficult to translate into quantifiable indicators but they are critical to the success of a legal system.

Certainty—Certainty is a critical element of any sound legal system. A grain of uncertainty in the legal position can have a pervasive and disproportionate effect. Once a banker hears that there is some doubt in the legal robustness of a transaction, he will fast become hesitant. The difficulty is one of measurement. If the legal uncertainty relating to a pledge or mortgage could be stated, for example, as a five per cent chance of proceeds on enforcement being reduced, with the amount of the reduction being on average twenty per cent, the risk would

be quantified and it would become easier to manage as there would be relative certainty. In reality legal opinions cannot be expressed in that way and the natural reaction to unquantifiable uncertainty is extreme caution. Transparency can often strengthen certainty: for instance, easy access for all to information in the land register allows potential mortgage lenders to find out about the property and any other mortgages that may be claimed.

Fit-to-context—The "fit-to-context" criterion is the most elusive but nonetheless important since it covers a number of facets. Simplicity, cost, speed and certainty are all concepts which are relatively easy to understand and to relate to economic benefit. The "fit-to-context" concept however merits more explanation. It is not enough to adopt a law which establishes clearly and unambiguously a simple, fast and inexpensive regime for pledge or mortgage security. The efficient functioning of the law will also depend on whether it is adapted to the economic, social and legal context within which it is to operate. It needs, for example:

a) To respond to the economic need: Markets are constantly changing, and the law has to be able to adapt to new products, as for example when loans are proposed with flexible interest rates;

b) b) To fit to the broader financial context within which the law operates: For example, the rules applicable to transfers and pledges of secured loans should not hamper the use of mortgage-backed securities and covered bonds and the secured transactions law should take into account the way in which pledge is used for securitisation transactions involving unsecured loans and other assets;

c) c) To fit with existing market practice: Whereas much can be learned from other markets, a law has to be compatible with existing market and legal practice and to give confidence to those who rely on it;

d) To achieve an appropriate balance between fulfilling the economic purpose and ensuring that the effects of the reform are acceptable in context: The rights of consumers and occupiers of property to appropriate protection cannot be eliminated to suit the economic needs of the secured transactions law, rather they have

to be framed in a way which enables borrowers and lenders to derive the benefits afforded by a flourishing secured credit market while at the same time ensuring the necessary protections to persons in a vulnerable position.

e) To achieve particular objectives of the law: For example, the law may aim to extend secured lending to a wide range of banks as opposed to creating a lending cartel, or to reduce constraints on the types of pledge and mortgage product that can be offered.

Legal Efficiency and the Functional Approach

An issue which can be used to illustrate the importance of the fit-to-context criterion is the functional approach to security interests over movable property. This was originally introduced under Article 9 of the Uniform Commercial Code in the USA. During the first half of the twentieth century there had developed a vast range of different rules and practices in the US that were applied for securing claims using movable property. In an attempt to introduce some order into what had become a somewhat chaotic and highly complex field of law, Article 9 provided for a unique set of rules, governing creation, notice filing, priority and enforcement, for *all transactions* whose function was to create a security interest in movable assets. Those rules apply irrespective of the form of the agreement between the parties if the substance of the transaction is to create a security interest. For example, an agreement between a buyer and seller of goods for title in the goods only to pass to the buyer upon full payment for the goods would not be effective as such, but would create a security interest over the goods with title passing to the buyer and the seller having a pledge in the goods.

In the context of the US in the 1950s the functional approach under Article 9 no doubt met the fit-to-context criterion. It was a key to providing a cure to the defects of the system that had prevailed until then and the sophisticated American market was able to understand it and apply it. In the very different context of transition countries the functional approach may be assessed otherwise. They have a lack, rather than a surfeit, of devices and practices for taking security. The introduction of a sophisticated concept of definition by reference to substance not form, and the recharacterisation of transactions that can result, does not fit easily with a civil law system and brings with it unnecessary complexity and uncertainty. Western European countries do not have a functional approach: England has recently rejected the

proposal that such system would be of benefit. Retention of title and financial leasing, fixed and floating charges, for example are used extensively. A country from central or eastern Europe thus needs to reflect carefully before adopting an approach which would bring considerable complexity and would touch on fundamental elements of its legal system such as freedom of contract[6] and ownership rights[7], whilst being diametrically different from the approach taken by its neighbours.

A few transition countries have adopted a functional approach (for example, Albania, Kosovo and Montenegro). No clear assessment has been made of the effect but anecdotal evidence suggests that the meaning of the relevant provisions has not been understood and that they are largely ignored in practice.

Measuring Legal Efficiency

Legal efficiency is thus relevant both when defining the general and detailed objectives for the reform and when subsequently measuring what has been achieved. A basic assessment whether a law maximises economic benefit may appear relatively simple. If the law enables a pledge or mortgage to be taken, and if necessary enforced, simply, quickly and cheaply the cost of security by way of pledge or mortgage is minimised and the benefit of the security is maximised. As we showed above, there are broader aspects that also have to be taken into account. Legal inefficiency may not merely reduce the economic benefit that might otherwise result from the law (for example a lower interest rate for a secured loan compared to that of an unsecured loan), it may also have a dissuasive effect. This is particularly pertinent to factors where the economic impact is difficult to measure. If the legal process is complex or takes a long time, or if there is uncertainty, potential players may never pass the decision threshold and not proceed with the transaction at all. If a few people take that line the impact may be multiplied as their conduct influences others.

Measuring legal efficiency is clearly challenging and any attempt to develop an accurate scientific basis is unlikely to be convincing. However, a close examination of a legal system against the legal efficiency criteria listed above can provide indicators of how efficient the system is. EBRD has done this for mortgage law in transition countries[8]

6. A contract for a financial lease or a credit sale or retention of title would be recharacterised as a pledge.

7. An agreement which purports to govern transfer of ownership has the effect of creating a pledge.

8. *See* EUR. BANK FOR RECONSTRUCTION AND DEV., MORTGAGES IN TRANSITION ECONOMIES (2008), *available at* www.ebrd.com/pubs/legal/mit.htm.

and it gives an interesting comparative insight into the strengths and weaknesses of existing legal regimes.

CONCLUSION

In most transition countries the basic reforms of the legal regimes for pledge and mortgage are well advanced, but there remains much work to do to assess those regimes and to fine-tune them to ensure that secured credit markets are supported by laws that are appropriate and conducive to the operation of the market for the mutual benefit of lenders and borrowers. We believe that the failure to define the general and detailed objectives of a reform and subsequently to measure what has been achieved against those objectives often prevents emerging markets from realising the advantages they should derive from legal reform programmes. The use of legal efficiency criteria provides a basis for bridging the gap between economic analysis and legal reasoning.