

Creating Credit from De Facto Collateral Rights

Steven L. Schwarcz

Key Points

- This policy brief attempts to solve a critically important practical problem: how to allow the poor to use the property they inhabit, but do not legally own, as collateral to borrow, in order to start small businesses and become upwardly mobile.
- This is a worldwide problem. Solving this problem would help to control, if not reduce, the widening gap between the rich and the poor, which threatens social and financial stability.
- This policy brief explains why commercial law should allow the poor to use their de facto rights as collateral, thereby empowering them with credit and facilitating a radically new conception of sustainable finance — attracting arm's-length funding, rather than being dependent on limited or unreliable charitable sources.

Introduction

The shrinking middle class and the widening gap between the rich and the poor pose serious threats to social and financial stability, and, indeed, the Group of Twenty (G20) leaders have committed to “help to reduce inequality and poverty.”¹ A major impediment to upward mobility is the inability of the poor to use their property, in which they sometimes hold only de facto, not de jure, rights, as collateral to obtain credit. This policy brief² takes a novel approach to overcoming that impediment, explaining why commercial law should — and analyzing how it pragmatically could — recognize those de facto rights to enable the poor to borrow to start businesses or otherwise create wealth.

1 “G20 Leaders’ Communiqué” (14 November 2014) at para 3, online: G20 Information Centre <www.g20.utoronto.ca/2014/2014-1116-communication.html>. The G20 continues strong in its commitment to reduce inequality and poverty. See e.g. “G20 Leaders’ Declaration: Shaping an Interconnected World” (8 July 2017) at Preamble, online: G20 Information Centre <www.g20.utoronto.ca/2017/2017-G20-leaders-declaration.html> (“We are resolved to tackle common challenges to the global community, including...poverty...and inequality,” as a “basis for sustainable development and stability. We will continue to work together with others, including developing countries, to address these challenges, building on the rules based international order”); Charles Riley, “World Leaders: We Must Tackle Income Inequality”, *CNN Money* (5 September 2016), online: <<http://money.cnn.com/2016/09/05/news/economy/g20-income-inequality/index.html>> (reporting that at the “G20 summit in China...world leaders did agree on one thing: the danger of rising income inequality”).

2 This policy brief is based on the forthcoming article by Steven L Schwarcz, “Empowering the Poor: Turning De Facto Rights into Collateralized Credit” (2018), online: <<https://ssrn.com/abstract=3167507>>.

About the Author

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Challenges

The World Economic Forum has identified wealth inequality as the biggest risk to the global community.³ The noted economist Hernando de Soto has explained how the lack of credit increases that inequality.⁴ He argues that the poor hold their resources in defective form, living in houses built on land that, de facto, is theirs but is not legally recorded as their property.⁵ The World Bank similarly estimates that, largely due to poverty, 70 percent of the world's population do not have registered title to their land.⁶

The poor therefore cannot use their homes as collateral to borrow and create wealth. The impact is devastating not only to individuals but also to commerce because mortgage lending is the primary source of capital used to start small businesses.

This poses important challenges. Should de facto rights — that is, rights that are respected in practice but not (yet) formally under official law — be recognized to enable the poor and other economically disadvantaged people (the economically disadvantaged) to use their homes and other commonly held assets as collateral to obtain credit? If such de facto rights should be recognized, how could that feasibly occur?

Proposal

This policy brief explains why commercial law should recognize those de facto rights to facilitate credit for the economically disadvantaged. It also analyzes how commercial law could be adapted pragmatically to implement that recognition.

3 World Economic Forum, *Global Risks 2014*, 9th ed (Geneva: World Economic Forum, 2014) at 13–14.

4 See Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York, NY: Basic Books, 2000) at 6. Although some empirical analyses have questioned the impact of policies based on de Soto's argument, the connection between property rights and access to credit remains a central tenet of the current efforts to alleviate poverty. See e.g. Peer Stein, Tony Goland & Robert Stein, "Two Trillion and Counting" (2010) World Bank Working Paper No 71315 at 9 (finding that ending poverty requires bridging the so-called "credit gap").

5 De Soto, *supra* note 4 at 5–6.

6 World Bank, "Why Secure Land Rights Matter" (24 March 2017), online: <www.worldbank.org/en/news/feature/2017/03/24/why-secure-land-rights-matter>.

Analysis

Modern commercial law already recognizes important policy goals and commercial realities as a basis to override traditional limitations imposed by property law. Although there are many examples,⁷ the leading precedent is the Uniform Commercial Code (UCC), perhaps the world's most respected codification of commercial law. This policy brief builds on the foundation provided by the UCC.⁸

Explaining How and Why Commercial Law Overrides Property Law

Property law does not necessarily reflect important commercial realities. To remedy this disconnect, the UCC articulates commercial law based on those commercial realities, in contrast to the “arbitrary shifting” of rights based on property.⁹

For example, the UCC allocates the risk of losing goods in shipment to the party who “control[s] the goods and can be expected to insure his interest in them,”¹⁰ whether or not that party owns the goods at the time of their loss.¹¹ This risk allocation is widely touted as providing “enormous” gains “in clarity, translatability and practicability.”¹² It has also been followed by the United Nations Convention on Contracts for the International Sale of Goods (CISG).¹³

7 See Schwarcz, *supra* note 2 (discussing how the commercial law of Germany, Japan and Chile, for example, recognizes important policy goals and commercial realities as a basis to override traditional limitations imposed by property law).

8 For largely path-dependent reasons, the UCC applies to security interests in personal property, but not in real estate *per se*. Nonetheless, the UCC's innovative principles – such as the disentanglement of commercial and property law – are compelling and should be valid regardless of whether the property at issue is personalty or real estate. This policy brief's analysis does not distinguish that nature of the collateral except as specifically indicated.

9 Cf UCC § 2-509 at Official Comment No 1 (observing that the “underlying theory” is to avoid “an arbitrary shifting of the risk with the ‘property’ in the goods”).

10 *Ibid* at Official Comment No 3.

11 UCC § 2-509, *supra* note 9.

12 John Honnold, “The New Uniform Law for International Sales and the UCC: A Comparison” (1984) 18 *Intl L* 21 at 27.

13 See *ibid* (observing that the CISG's rules “on risk of loss are closely patterned on the modern rules of the UCC. The approach is the same: the elusive concept of property...is not employed. Instead, the Convention's rules are drafted in terms of concrete commercial events – handing over goods to the carrier and the buyer's ‘taking over’ physical possession from the seller”).

The UCC also overrides property law to recognize important policy goals. For example, to facilitate the transferability of goods, it gives good faith purchasers greater rights in the transferred goods than the seller had.¹⁴ This recognizes that buying goods (such as a computer) from a store would be prohibitively expensive if, to protect the purchase, the purchaser had to perform due diligence on whether the store actually owned the computer and whether the computer might be encumbered by any third party rights.

Explaining Why Commercial Law Should Override Property Law to Empower the Poor

Commercial law thus recognizes important policy goals and commercial realities as a basis to override traditional limitations imposed by property law. Enabling the economically disadvantaged to pledge *de facto* rights in their homes and other assets as collateral to obtain credit is not only an important policy goal but also represents an important commercial reality because the *de jure* owner is not using the property commercially, while the *de facto* right holder is motivated to use it. Further, *de facto* rights are real rights, although not formally recognized.

In order to turn these *de facto* rights into collateralized credit, the economically disadvantaged would need to be able to transfer security interests in their property to lenders, as collateral for loans. Lenders, however, are unlikely to provide credit that is secured merely by *de facto* rights in collateral. In a foreclosure, they almost certainly would want to obtain full rights in the property pledged as collateral.

This poses a puzzle: how could holders of *de facto* rights transfer more rights than they hold?¹⁵ This policy brief attempts to solve that puzzle next, as well as to answer other questions that would be raised by creating credit from *de facto* rights.

14 See *infra* notes 16–17 and accompanying text (discussing holders in due course of instruments and buyers in ordinary course of goods).

15 The long-standing property law principle of *nemo plus iuris transfere potest quam ipse habet* creates this puzzle: no one can transfer more rights than he himself has.

How Could Holders of De Facto Rights Transfer More Rights Than They Hold?

Commercial law already addresses this puzzle. To facilitate the transferability of negotiable instruments (such as promissory notes), commercial law gives so-called holders in due course unencumbered rights to these transferred instruments.¹⁶ Similarly, to facilitate the sale of goods, commercial law gives buyers of goods in the ordinary course of business unencumbered rights to those goods.¹⁷ If commercial law did not override property law in these ways, the transaction costs of negotiating instruments and selling goods would become prohibitive.

Similarly, overriding property law to give foreclosing lenders full rights in the property pledged as collateral — which, as mentioned, would realistically be a condition to their lending — would facilitate the important policy goal of providing credit to the economically disadvantaged, thereby unlocking the entrepreneurial potential of billions of people. It also would recognize the important commercial reality that the de jure owner is not using the property, while the economically disadvantaged may be motivated to use it.

This policy brief therefore maintains that foreclosing lenders should have the ability to obtain full rights in the property pledged as collateral.

Would Recognition of De Facto Rights Be Unfair to Holders of De Jure Rights?

Giving foreclosing lenders full rights in the property pledged as collateral would cut off the holders of de jure rights, which could be unfair. Commercial law constantly grapples with conflicting rights and the need for fairness.

Recall that a holder in due course can receive the transfer of an encumbered instrument — even one that is already subject to third party rights, such as a lien — effectively free and clear of the encumbrance. The implicit fairness rationale is that

the party with the original encumbrance could have preserved its rights by providing clearer notice of those rights to subsequent transferees.¹⁸ Similarly, the implicit fairness rationale for allowing a buyer of goods in the ordinary course of business to obtain full and unencumbered title to the goods is that parties with the original encumbrance or title could have preserved their rights by providing clear notice thereof.¹⁹ Providing clear notice to preserve original rights also has precedent in the somewhat parallel tension between the de jure rights of landowners and the de facto rights of squatters.²⁰

This same type of approach — recognizing the original de jure rights of persons who provide clear notice to preserve those rights — should similarly respect fairness, while helping to promote the effective utilization of property. Any such notice, however, should not be allowed to otherwise impair de facto rights; for example, it may not impair the right of economically disadvantaged persons to continue living on or using property. Also, to ensure that notices reflect the current intentions of de jure right holders, any such notices should expire after a reasonable time period.²¹

That calls into question, however, whether de jure right holders would always give notice, thereby preventing foreclosure on their property (and thus effectively preventing it from being used as collateral). In answer, relatively few de jure right holders are likely to know of their rights; it is unclear who, other than the government, owns much of the property in which the economically disadvantaged hold de facto rights.²²

¹⁶ UCC § 3-305.

¹⁷ See e.g. UCC § 9-320 (providing that a buyer of goods in the ordinary course of business takes free of a security interest created by the seller of the goods, even if the buyer knows of the security interest's existence); UCC § 2-403(2) (providing that the entrusting of possession of goods to a merchant who deals in goods of that kind gives the merchant power to transfer all rights of the entruster to a buyer in the ordinary course of business).

¹⁸ See UCC § 9-330 at Official Comment No 7.

¹⁹ The Official Comments to UCC § 9-320 clarify, for example, that a buyer purchases goods subject to a security interest if the buyer is informed that its purchase is intended to be so encumbered. If a buyer purchasing goods entrusted to a merchant is informed that the merchant's right to sell the goods is limited, the buyer would not be a "buyer in the ordinary course" for the purposes of UCC § 2-403.

²⁰ In most jurisdictions, squatters can ultimately obtain superior rights over the land they occupy under the law of adverse possession. The original owner, however, can preserve their rights by providing explicit notification, such as posting a no trespassing sign or blocking entry to the land.

²¹ Schwarcz, *supra* note 3, discusses these requirements in detail.

²² Cf World Bank, *supra* note 6 (observing that, in many parts of the world, people simply do not know what their property rights are, and, even if they try to find out, they cannot receive accurate information from government agencies). That raises the question of whether it is fair to impair property rights of persons who are unaware they hold such rights. The law has a long tradition, however, of cutting off those rights, epitomized by escheatment law that treats bank accounts as abandoned if the customer cannot be contacted.

If the government itself owns the property in which the economically disadvantaged hold de facto rights, the question of fairness would be less critical, devolving instead into a political issue. This policy brief suggests that the government should subordinate its de jure rights to the rights of the economically disadvantaged.

How Could De Facto Rights Be Clearly Identified?

To satisfy lenders and create credit, commercial law must clearly define and identify de facto rights in collateral. However, existing real estate recording systems only identify de jure rights, and they tend to use metes and bounds or other parameters for identification that might not always be practical to describe de facto rights.

De Soto addressed this question by arguing that economically disadvantaged people have developed their own ways of determining who owns what, as part of “extralegal social contracts,” and that any reform should be based on — or at least rooted in — these behavioural norms and customs.²³ When travelling through Indonesian rice paddies, he observed to government officials that there was no clear way of knowing where one farmer’s land ended and another’s began, but “the dogs knew.”²⁴ Every time he “crossed from one farm to another, a different dog barked.”²⁵ One of the Indonesian officials characterized this allocation of rights as “*Jukum Adat*,” the people’s law.²⁶

Although a people’s law approach has strong commercial law precedent,²⁷ it might not sufficiently identify the collateral to satisfy lenders. Technology, however, provides an alternative approach. Either the government, a non-governmental organization or, in some cases, perhaps a local neighbourhood association could organize the residents to allocate their de facto property rights by setting visible markers at the boundaries. Satellite, drone or other overhead imagery could then document those markers for

translation into an accurate and easily ascertainable description of those allocated boundaries. The law would respect that allocation if it followed a prescribed methodology, which need not fit within the jurisdiction’s existing mortgage-recording system. The allocation would be transcribed to a government record that lenders could search.²⁸

Would Lenders Be Prepared to Extend Credit?

Would banks and other lenders actually extend credit to economically disadvantaged borrowers, based primarily on collateral? Although that can only be answered empirically based on what lenders actually do, the following observations may inform the answer.

The key to asset-based lending is that the loans be sufficiently overcollateralized — that their collateral value exceed the amount of the loan by a reasonable margin, enabling repayment in the event of a default.²⁹ In this policy brief’s concept of extending credit to economically disadvantaged borrowers, prudent lenders would insist that their loans be sufficiently overcollateralized. Although lenders could also be repaid from the profits of small businesses started with the proceeds of their loans, that source of repayment would be uncertain because, as will be discussed, small business start-ups have a high failure rate.

Abuses leading up to the global financial crisis of 2007–2008 have created uncertainty, however, for asset-based lending to economically disadvantaged borrowers. Lenders had made massive amounts of so-called “subprime” mortgage loans to such borrowers, depending on the expectation of housing-price appreciation for repayment.³⁰ When housing prices failed to appreciate, and in many regions began to depreciate, lenders — as well as investors in securities backed by these mortgage loans — suffered huge losses.³¹ As a result, subprime asset-based loans are perceived as inherently risky.

In reality, however, whether subprime asset-based loans are actually risky depends on the extent of overcollateralization. Prudent asset-

²³ De Soto, *supra* note 4 at 172–75.

²⁴ *Ibid* at 163.

²⁵ *Ibid*.

²⁶ *Ibid*.

²⁷ For example, UCC § 1-303 recognizes course of performance and course of dealing.

²⁸ Schwarcz, *supra* note 2, discusses these steps in detail.

²⁹ *Ibid*.

³⁰ *Ibid*.

³¹ *Ibid*.

based lending should never have to depend — as subprime mortgage lenders depended prior to the financial crisis — on the expectation of collateral appreciation for overcollateralization. Instead, prudent subprime asset-based loans should be adequately overcollateralized at the outset, when they are made.

The reason why pre-crisis subprime mortgage lending failed that standard — while extending credit to economically disadvantaged borrowers secured by their de facto rights should meet it — turns on basic principles of purchase-money lending. A subprime mortgage loan is a purchase-money loan: a lender advances funds to an economically disadvantaged borrower to purchase a home, and the borrower pledges the home as collateral for the loan. Because economically disadvantaged borrowers rarely have money to make a down payment, the amount of the loan usually must equal the purchase price of the home.³² The loan, therefore, is not overcollateralized when made; it depends on an expectation of home appreciation for overcollateralization.

In contrast, loans made to economically disadvantaged borrowers, secured by their de facto rights, as contemplated by this policy brief, are not purchase-money loans. The borrower already has those de facto rights. A lender would extend credit based on its valuation of the collateral, with prudent lenders insisting on overcollateralization. Although this prudent lending standard will restrict the relative amount an economically disadvantaged person could borrow against his de facto rights, that amount may well be sufficient to start a viable small business.³³

If necessary, this policy brief's proposal for borrowing based on de facto collateral rights could be supplemented to induce lenders to advance higher amounts. For example, some communities might consider providing cross-guarantees of repayment, which is typical in microfinance lending. Governmental or multi-governmental entities might also consider helping to partially or fully guarantee loans in order to attract private credit or even making loans directly from public resources.³⁴

32 *Ibid.*

33 *Ibid.*

34 See *ibid* (discussing these options).

Would the Poor Be Willing to Borrow?

People tend to be risk averse. A person who lives on land (or otherwise uses property) may be unwilling to risk losing it in a foreclosure, even if taking that risk brings the chance to start a successful small business.

This policy brief does not purport to reliably predict how many economically disadvantaged persons would be willing to turn their de facto rights into collateralized credit. It merely observes that people invest their life savings into small businesses all the time. Moreover, if necessary to motivate the economically disadvantaged to borrow, governments could consider subsidizing the resulting businesses or providing back-up housing as a safety net for borrowers whose businesses fail.³⁵

Explaining Why Overriding Property Law to Empower the Poor Would Be Economically Efficient

This policy brief has explained from a legal standpoint how and why commercial law should override property law to enable the economically disadvantaged to use their homes and other commonly held assets as collateral. Such a legal change, however, would have broad policy ramifications.

When considering a change in law that has significant policy consequences, the norm is to examine whether the benefits would justify the costs of the change. Although referred to in a regulatory context as a cost-benefit analysis, this is effectively a Kaldor-Hicks economic efficiency analysis.³⁶ A project is Kaldor-Hicks efficient if its overall benefits exceed its overall costs, regardless of who bears the costs and who gets the benefits.

Estimating Anticipated Benefits

The anticipated benefits of enabling the economically disadvantaged to obtain credit are incalculable. Assuming the disadvantaged use it to start small businesses, credit not only can greatly help to alleviate poverty but also can foster economic development — thereby

35 See *ibid.*

36 *Ibid.*

helping to strengthen both social and financial stability. Economic development also has the secondary benefit of creating additional jobs.

Estimating Anticipated Costs

The principal costs of overriding property law to enable the economically disadvantaged to obtain credit are threefold: direct harm to owners of the underlying de jure rights; potential subversion of the rule of law; and the loss of property by economically disadvantaged borrowers whose ventures fail. Additionally, there are transaction costs.

Owners of the underlying de jure rights would be harmed if a lender forecloses on, and thus obtains ownership of, their rights. Foreclosure would occur only if the borrower defaults. Ideally, borrowers who successfully invest the loan proceeds in small businesses should realize profits that enable them to repay the loans, avoiding foreclosure. Nonetheless, assuming a worst case that half of all such businesses fail,³⁷ the owners of the underlying de jure rights to that collateral would be harmed. Although it is hard to try to quantify that harm, it might reach hundreds of millions of dollars, if not more.

Owners of the underlying de jure rights might also be harmed if their rights are merely encumbered by a lender's security interest. That would limit the owners' practical ability to transfer their rights or to use those rights as collateral to raise funding. It is even harder to try to quantify this harm.

These harms to owners of the underlying de jure rights would be mitigated, however, by two factors. First, this policy brief proposes to enable such owners to provide clear notice of their rights, thereby protecting those rights. Second, the fact that such owners tolerate or are unaware of the economically disadvantaged using their property indicates that they have little (at least current) interest in transferring their rights or using those rights as collateral to raise funding.

The potential subversion of the rule of law represents a second principal cost. This cost, however, should be relatively modest. As this policy brief discusses,

commercial law already has set strong precedents for overriding property law to achieve important policy goals and commercial realities. Furthermore, the law of adverse possession provides additional precedent for favouring de facto rights over de jure rights in circumstances similar to those discussed.

A third principal cost is the loss of property by economically disadvantaged borrowers whose ventures fail. As discussed, around half of start-up businesses fail. A borrower who loses her property in a foreclosure may become homeless. Even if the government provides a safety net, the costs involved might run hundreds of millions of dollars more.

Overriding property law to enable the economically disadvantaged to obtain credit also entails transaction costs. These include the costs associated with using satellite, drone or other overhead imagery to document de facto rights and costs associated with translating that into descriptions of allocated boundaries.³⁸ Even if these costs add up to tens of millions of dollars, they would be relatively small compared to the two hundreds-of-million-dollars cost estimates above.

Balancing Costs and Benefits

The anticipated benefits of enabling the economically disadvantaged to obtain credit are incalculable, greatly helping to alleviate poverty, thereby strengthening social stability, and also helping to foster economic development, thereby strengthening financial stability. Although the costs might be many hundreds of millions of dollars, if not more, the benefits should well exceed those costs. In that case, this policy brief's proposal — to enable the economically disadvantaged to obtain credit by using their de facto rights as collateral — would be economically efficient.

The fact that the benefits and costs accrue to different parties — the benefits to the economically disadvantaged who hold de facto rights, the costs to the owners of the underlying de jure rights — is irrelevant to this conclusion. Economic efficiency is satisfied if the overall benefits exceed the overall costs, regardless of who benefits and who loses.³⁹

37 Cf Patricia Nilsson, "London Start-ups Are Most Likely to Fail", *Financial Times* (12 October 2017), online: <www.ft.com/content/e3c745c4-88d8-11e7-afd2-74b8ecd34d3b> (reporting that "London has the lowest rate of start-up survival in the UK: only 50.1 per cent of companies formed in 2013 endured for three years, 3.6 percentage points below the national average").

38 See *supra* notes 27–28 and accompanying text.

39 See Schwarcz, *supra* note 2 and accompanying text.

Implementation

Changing the law to enable the economically disadvantaged to use their homes and other commonly held assets as collateral would have broad policy ramifications. Legislatures, which have the capacity to hear multiple competing constituencies and to fully debate competing ideas, should consider such fundamental changes. Legislatures are additionally well positioned to implement this policy brief's framework because it is technical and deals with a somewhat specialized area of law — secured transactions. Most ordinary judges are unlikely to have sufficient commercial law background to attempt to implement the framework.⁴⁰

To facilitate legislative adoption of this policy brief's framework, that framework has been written into a Model Law.⁴¹ The article on which this policy brief is based not only sets forth the text of such a Model Law but also explains its provisions in context.⁴²

Recommendation

If the G20 countries concur with this policy brief's proposals, they should call on nations, including developing countries, to amend their commercial law accordingly. That amendment could easily be implemented through legislative enactment of the text of the Model Law.

⁴⁰ Because judges address fact-specific cases and controversies, they are also highly unlikely to have a sufficient mandate in any given case to implement the entire framework.

⁴¹ See Schwarcz, *supra* note 2 at Annex 1 (Model Law).

⁴² See Schwarcz, *supra* note 2.

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