Mechanisms for Creating Liquidity in a Rural Setting:

A Description of Existing Banking and Financial Regulations in Guatemala, Nicaragua, and El Salvador for Using Cattle and Trees as Loan Collateral

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1. EXECUTIVE SUMMARY

The public and private banking entities in Guatemala, Nicaragua, and El Salvador are supervised and overseen by their respective financial superintendencies. In Guatemala this entity is called the Bank Superintendency, in Nicaragua it is known as the Bank and Other Financial Institution Superintendency, and in El Salvador it is the Financial System Superintendency. These financial entities are governed by the legal dispositions established by each.

Based on what is established in the banking and finance legislation, the superintendencies are empowered to ensure that the public and private (commercial) banking entities under their command comply with the requirements they must meet. They are governed by following the directives that are dictated to them (Appendices 1, 2, and 3 – the Superintendency Laws of Guatemala, Nicaragua, and El Salvador, respectively).

In relation to accepting liens on cattle and trees as loan collateral, the laws in Guatemala, Nicaragua, and El Salvador do not include the latter assets as an option for granting loans. In all cases, the law empowers public and private commercial banks to do so specifically for cattle (Appendices, 4, 5, and 6 – the Bank Laws for Guatemala, Nicaragua, and El Salvador, respectively). These same entities, under banking and national legislation in general, must consider within their objectives and internal policies whether they accept this collateral. Thus, they are the last recourse that, by assessing the risks and following the norms set down by their respective superintendency and their banking system's laws, place it in practice.

Nevertheless, although these countries legally allow the state and private banks supervised and overseen by their respective superintendency to use this collateral, it is not done regularly so there is no official knowledge of how many and which banks do so. It is known that most banks offering this possibility to their trusted customers are state banks. Therefore, they include it in their internal policies. Private banks are very unlikely to consider it, based on conversations with the bank employees.

For trees as loan collateral, the banking system in each country disallows it or at least it is not very clear whether it may be done, since the institutions in charge of forestry in each country are unaware of it being able to be done, although their legislation does in fact speak of accepting fruit from trees as collateral but not the trees as such (Appendices 7, 8, and 9 – Forestry Laws of Guatemala, Nicaragua, and El Salvador, respectively).

None of the Ministries of the Environment for each of the countries include trees from forest plantations as collateral when the owner has access to a loan and wants to use them as a possibility. The only thing allowed is granting loans to pay for environmental services for people who have forests or plantations and who legally and formally have management plans

(Appendices 10, 11, and 12 – Environmental Laws in Guatemala, Nicaragua, and El Salvador, respectively).

In summary, the financial legislation in these three countries that was examined clearly allows granting loans ensured by a lien on cattle, and the banking entities that grant this option have their own respective requirements and procedures for verifying the existence of the assets put up for collateral so they can cover the risk of default, among other issues. One should be guided, however, by what is set forth in the respective Bank Law (Appendices 4, 5, and 6 -- Guatemala, Nicaragua, and El Salvador, respectively). Mostly, the state banking entities are the entities who have this practice, but only for customers who have a long track record with them and a great deal of credibility. There are, however, some isolated cases, based on conversations with employees from some of the banks.

1.1 Report Objectives

1.1.1 General Objective

- Provide a description of the laws, regulations, and legal and financial decrees existing in Guatemala, Nicaragua, and El Salvador related to using cattle and trees as collateral for a loan that entrepreneurs in the rural sector request from financial entities.

1.1.2 Specific Objectives

1. Identify the legal regulations, financial laws and current practices of the financial superintendencies related to accepting common rural assets (cattle and trees) as securities or collateral for a loan.
2. Identify the current laws and regulations, specifically for cattle and trees, that indicate that they may be used as collateral for a loan, as well as the national and banking restrictions on using this sort of collateral.

2. METHODOLOGY

To create this report based on its proposed objectives, the following activities were carried out:

2.1 Collect Secondary Information

To create this report, the first step was to search for information on the Internet (state and banking laws, decrees, regulations, etc.). Therefore, the report's appendices are mostly documents extracted from web pages pertaining to the respective organizations or governmental entities.

Then, steps were taken to gather additional information for each of the countries in the study to fill in the voids or information deficiencies through interviews held by telephone with the managers of some state and private banks, engineers from the Ministries of Agriculture and Livestock, and engineers from the Ministry of the Environment. Finally, an attempt was made to speak with forestry attorneys to gather additional information relative to using trees as a security for a loan application, although the response was mostly unsatisfactory.

2.2 Information Systematization

After gathering the secondary information, it was systematized, just retaining the issues that are directly linked to the study and that make reference to the pertinent articles of law for each particular case. Likewise, the identified information was enriched with the contributions by the people consulted by telephone and by the receipt of information that some had sent via e-mail.

Chapter 3 on the results and discussion of the gathered information describes each case, first the case for Guatemala, then for Nicaragua, and lastly for El Salvador. This chapter is divided into two parts. The first part refers to the financial laws and specific practices of each country's superintendencies relating to the power they give the state and private banks to use common rural assets as securities for a loan application. Finally, part two indicates the current financial laws and norms, as well as the chapters and articles for each of them, in relation to this report's purpose. In addition, it indicates the existing national and banking restrictions about this situation and how these assets are appraised. Likewise, a final chapter is included that summarizes the primary report conclusions.

3. RESULTS AND DISCUSSION

3.1 Financial Laws and Current Superintendency Practices on Common Rural Assets Used as Securities or Collateral for a Loan

3.1.1 Guatemala

The Guatemalan Superintendency of Banks is the Central Bank organization in charge of overseeing and supervising the country's registered financial entities so they maintain adequate liquidity and solvency to function properly. Thus, in the Bank Superintendency Law, Chapter 1, Bank Superintendency, Article 1 mentions its nature and objectives; Article 2 refers to supervision, and Article 3 is related to the functions that it should fulfill as a supervisory entity. Nevertheless, this law does not directly establish whether this entity allows banking organizations to accept cattle or trees as security or collateral for a loan granted by a financial entity, since it basically addresses the issues related to its own functions.

The Guatemalan Constitutional Bank Law (Appendix 13) and the Monetary Board support the Superintendency. In addition, the latter is the entity to which the Superintendency must be accountable. However, this law does not mention anything about cattle and trees. Only Title IV on bank operations, Chapter 1 (Loans) mentions in its Article 48 its function as a last stance lending bank that offers all the banks the solvency necessary when they have temporary liquidity shortfalls.

3.1.2 Nicaragua

The Nicaraguan Superintendency of Banks and Other Financial Institutions, just as with the other two countries in the study, is the entity in charge of authorizing, supervising and pursuing the constitution and functioning of all banks, branches, and banking agencies operating in the country, whether they are state or private, domestic or foreign (the Superintendency Law, Chapter 1, Law Objectives and Functions, Articles 1 and 2).

The Superintendency must comply with a series of attributes so it fulfills the purposes for which it was created. Chapter 2 describes each attribute which must be followed so as to not commit any misdemeanor or crime as set forth by the country's Bank Law.

The Central Bank Constitutional Law (Appendix 14) must be obeyed by the Superintendency and, therefore, by the banking system that it supervises. Nevertheless, given this study's interest, none of these laws clearly establishes anything that has a direct relationship with the rural assets in question. Instead, they set forth guidelines that the banks must follow. Their specific functions are established in the Bank Law.

3.1.3 El Salvador

The El Salvador's Financial System Superintendency supervises, oversees, ensures compliance with the law, and sets down norms that must be followed (the Constitutional Law of the Financial System Superintendency, Chapter 1, Superintendency, Article 1). However, this law does not indicate anything about types of guarantees and, consequently, the types of securities for them.

The Superintendency is the organization in charge of performing the public and private financial entity oversight and supervision. Other laws are directly related to what the banks should do in terms of what sort of loans can be granted, etc.

3.2 National Financial Laws and Current Norms on Common Rural Assets (Cattle and Trees) Used as Security or Collateral for a Loan, Existing Restrictions, Risks, and Appraisals for This Type of Asset

3.2.1 Guatemala

Based on conversations held with Mr. Sergio Girón (the Banco del Occidente de Guatemala representative), in the Civil Code (Appendix 16), Articles 904 – 916 and Articles 1125, reference is made to agrarian, cattle, and industrial collateral. Articles 880 – 903 mention common collateral, where it is manifested that cattle may indeed be accepted as collateral for a loan. In addition, Articles 442 and 455 mention real property (including cattle) and other property.

According to engineer Oscar Gaitan of the National Forest Institute (INAB in Spanish), this country's Forestry Law only refers to the fact that forests can be used as a guarantee for reforestation (Title 4, Chapter 1, Forest Use and Management, Articles 56 and 57). The Law only mentions mortgage collateral.

For cattle, the Bank Law in Title IV, Chapter 1, Articles 50 to 58, touches on financing and the guarantees that banks may accept. Among the issues laid out in the Law are: chattel bonds and the requirements that banks must follow in granting a loan; asset appraisals; contingencies and other financial risks; risk ratings; and extraordinary assets. Article 55 mentions related risks. Finally, Articles 56 to 58 make an allusion to the administrative policies, internal controls and the risk information systems available in case the debtor defaults on the guarantee.

Upon reviewing the legislation pertaining to Guatemala's Ministry of the Environment, called the Environmental Protection and Improvement Law (Appendix 10), nothing was mentioned about these types of assets. This means that the fact that forest plantation trees can be used as security for any type of loan requested by rural entrepreneurs was left out of the Law.

In conversations held with officials from Guatemala's Ministry of Agriculture and Livestock, they recognize knowing that the cattle can be used as security, but they are also unaware whether this currently is applicable to banking institution practices or the practices of other types of financial institutions in the country.

Lastly, speaking with public and private bank personnel, no financial regulatory terms as such exist in the banks' internal policies on banks granting loans and accepting this type of asset as collateral. Since each banking entity is governed by the national banking law, each creates its own internal conditions for granting them. The only difference from the other types of existing loans is that the bank will take the risk level and loan size into account. When it corroborates whether the security exists or not, it will assess the feasibility of granting the loan or not.

When the security being accepted is cattle, the bank calculates the loan amount that the customer is applying for based on the market price per head of cattle. This price is unknown, since it varies depending on the terms settled upon between the bank and the loan applicants and is estimated when the accredited agronomic engineer or expert goes to the site and does the appraisal. Thus, depending on the conditions the bank stipulates with the customer, the security will pertain to a determined number of heads of cattle, calculated based on the loan amount and the established market value per animal in place at that time. There is the exception that the animal must be branded so the animal being provided as collateral is marked. This process occurs after the bank has corroborated the veracity of the information requested by the customer.

3.2.2 Nicaragua

The General Bank Law, in Chapter V, Resources, Loans, and Other Operations, Article 47 on bank operations, mentions that banks can grant guarantees as obligations to make payment (among other things). Article 48 mentions aspects related to bonds and guarantees, while Article 50 establishes the guarantee limitations as indicated by the bank. Chapter VI, on legal privileges and procedures, Article 53, Section 9, speaks about agrarian or industrial securities, indicating that for legal purposes they must be registered in the appropriate Registry in case the banking entity's customer defaults.

Article 55 of the Bank Law establishes how banks attach securities. Article 56 speaks about the procedure to follow to sell the security legally. Both instances are in case the loan is in default based on the contract established between the bank and the customer.

Conversations held with Mr. Milton Caldera (an officer in the Credit Department at the Banco de la Producción, BANPRO) indicate that in Nicaragua using cattle as a security for a loan application has indeed been practiced for many sorts of projects. However, he is currently unaware if any cases like this exist since based on his perception, mostly the state banks have applied this practice.

Conversations with representatives of the National Forestry Institute (INAFOR in Spanish), which is regulated by the Forestry Law, indicated that they are unaware whether cases have occurred in which plantation or forest trees have been provided as collateral. According to what the law establishes in Chapter X, Incentives for Forest Development, Article 43, mention is made that natural forests and forest plantations can be mortgage or chattel security for mercantile purposes, using the forest or plantations as the real property appraisal. It establishes, however, that if the security is seized neither the bank nor third parties will be given authorization for forestry exploitation. In other words, they cannot extract lumber, which is why – in their opinion – cases such as this have not been used by the country's banks.

3.2.3 El Salvador

Title III, Financial Operations and Services, Chapter I, Article 1, establishes the types of general bank operations indicating that loans can be granted so long as they are allowed by law. Likewise, Chapter 6, Extraordinary Assets, Article 71, says that banks can accept all types of collateral and acquire real and other property.

In addition, the Bank Law, Article 94, Section C (Asset and Liability Exclusion and Transfer), indicates (in reference to excluding assets) which assets the bank can appropriate when they are chattel or mortgage guarantees. Article 95 mentions how to transfer the assets and section D speaks about legal intercession if it should be necessary. However, nowhere does it specifically mention whether cattle or trees, as such, can be used as security.

The Code of Commerce (Appendix 15), Chapter II, Production Credit, Section A (the Nature of Credit – Security Purposes), Article 1143, mentions livestock or cattle production for loans. Strengthened by Article 1144, it says that to secure production loans, animals and other property used in rural operations and products can be given as collateral. The Banco Salvadoreño legal assistant indicated that, at times, fruit from trees have been recognized as security for a loan application but there have never been cases where the trees are placed as a security.

Mr. Milton Guardado (the Credit Area Representative for the Banco Agrícola de El Salvador) recognizes that cattle has upon occasion been provided as security, but just as with the other parties interviewed, he is unaware of trees having been used for these purposes. However, he did say that the fruit of trees (harvests) have been used this way.

Based on what the Forest Law indicates in Chapter II, Managing Private Forest Plantations and Allowed Usages, Article 16 on private forest plantations indicates that privately owned plantations do not require any authorization for maintenance, thinning, and finally logging, but transportation, marketing, and industrialization are subject to what the law dictates. However, no part of the Law says that trees can be used as collateral, so it is insufficient for the country to use this option as an incentive. In fact, it is unknown whether the banking entities have done so or are currently doing so.

USING A BILL OF SALE AS GUARANTEE OF OWNERSHIP IN SALVADOR

According to engineer Samuel Salazar[1] (Executive Director of FIAGRO[2]), there existed an old practice (last century) for securitizing animals from a hacienda or farm (oxen, cows, horses). Due to hard times and robbery, the municipality required a witness to confirm the ownership of the animal and branding. With this evidence, the municipality issued a property title called “Carta de Venta” (Bill of Sale) for the owner of the animal.

The Bill of Sale was a certificate testifying to the number of animals owned, the class of animal (cow, steer, horse), and the brand logo used to mark the animals on their hindquarters, among other things. The Bill of Sale could be used by the owner as a “guarantee of ownership” for anybody – usually someone he knew – to ask for a loan to acquire anything needed for production, including buying more animals or feed, improving the infrastructure, buying tools or equipment, etc. This document, however, only indicated who owned the animals, not how much they were worth.

Therefore, if the owner applied for a loan and the other party accepted giving it to him, the document was endorsed over to the person granting the loan. Prior to doing so, depending on the amount of the loan being requested, they both appraised the number and price of the animals to carry out the transaction. In addition, if the loan was for a deposit, the applicant gave the Bill of Sale to the creditor and the rest was stipulated between them according to the need.

Currently, this practice has fallen into disuse since the rancher or property owner no longer needs to have bills of sales for the animals on the property and, therefore, the mayors’ offices are no longer asking for it. However, in a spot in a departmental capital in the center of the country, called Suchitoto – along with other small towns – this practice is still in place. It has remained a custom of the animals’ owners as a way for them to brand and identify their property. In addition, the Bill of Sale is used as a guarantee to gain access to loans based on their needs.

4. CONCLUSIONS

- In general terms, in Guatemala, Nicaragua, and El Salvador cattle are the only asset used as security. In all cases, the average animal value is unknown since in all cases, and based on telephone conversations, calculating the value is the responsibility of the expert in charge of the appraisal. Likewise, the animal must first be registered in the Property Registry in each country to obtain the “brand” – the stamp or mark that identifies

[1] Engineer Salazar points out that FIAGRO has no relation to the Bill of Sale practice to which he makes reference and that he is only explaining what he currently knows about it. E-mail for Engineer Samuel Salazar: de@fiagro.org.sv

[2] Fundación para la Innovación Tecnológica Agropecuaria (FIAGRO). Telephone: (503) 267-0069; Fax: (503) 267-0000 ext. 549; E-mail: info@fiagro.org.sv; web page: www.fiagro.org.sv

the animals (cows) belonging to a particular businessman. Thus, to cope with a loan application, it is the bank's responsibility to be sure that the information supplied by the customer is true and, therefore, corroborate *a priori* whether the cattle exist, verify that they belong to the person in question, and be sure that there is no encumbrance on the cattle that could block or impede foreclosing on the security if there is a default on the loan.

- If there is a default on the loan in any of the cases where the asset has to be taken to court and later auctioned to cash it in, each country's bank laws specify the procedure to be used, as well as the risks involved.

- The state and private banks in the three countries are in charge of deciding whether to offer this type of option for a rural businessman in their internal policies. Therefore, they have to decide what requirements to request. There is no defined regulation for this since what is most important for any type of loan is to verify that the security exists, that everything is in order, and that periodic visits are made based on the length of the loan. The rest is something that is applied to all customers, in general.

- Since it is unusual for banks to provide this service to their customers because this type of loan is not used very often and for some may not be totally trustworthy, the market size was unknown in all the cases. In other words, the number of financial and banking entities granting loans by accepting these rural assets as security cannot be specified since, although the laws allow them – specifically for cattle – few banks currently provide this service and the ones that do have mostly been public banks.

- In regard to the reserve requirements that the financial entities estimate when they grant loans with the cattle security, for issues relative to the risk value, each bank's constitutional law and the bank and superintendency laws clearly specify these situations.

- Based on these statements, it cannot be said with certainty whether there is a difference between what the law sets down and what the parties (bank and debtor) do in practice. The only thing that may be sure is that under the legislation it is clear what type of asset may be taken as a security and that the businessmen cannot go against the law. Neither of the parties would benefit from providing false information or failing to comply with the law since it is each bank's responsibility to ensure that all the information provided by the customer is true.

5. APPENDICES

Appendix 1
THE GUATEMALAN SUPERINTENDENCY OF BANKS

Appendix 2
THE NICARAGUAN SUPERINTENDENCY OF BANKS AND OTHER FINANCIAL INSTITUTIONS

Appendix 3
THE SALVADORIAN SUPERINTENDENCY OF THE FINANCIAL SYSTEM

Appendix 4
THE GUATEMALAN BANK LAW

Appendix 5
THE NICARAGUAN BANK LAW

Appendix 6
THE SALVADORIAN BANK LAW

Appendix 7
THE GUATEMALAN FORESTRY LAW

Appendix 8
THE NICARAGUAN FORESTRY LAW

Appendix 9
THE SALVADORIAN FORESTRY LAW

Appendix 10
THE GUATEMALAN ENVIRONMENTAL LAW

Appendix 10
THE NICARAGUAN ENVIRONMENTAL LAW

Appendix 12
THE SALVADORIAN ENVIRONMENTAL LAW

Appendix 13
THE GUATEMALAN CONSTITUTIONAL BANK LAW

Appendix 14
THE NICARAGUAN CONSTITUTIONAL CENTRAL BANK LAW

Appendix 15
THE SALVADORIAN CODE OF COMMERCE