

Pledge of Securities as a Method to Ensure Fulfillment of Loan Liabilities

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Abstract—Peculiarities of pledging of securities as a method to ensure fulfillment of loan liabilities, its advantages and disadvantages as collateral form the most complicated aspect, both theoretically and practically. The complications with this type of collateral are related to a lack of special provisions in the current legislation of the Republic of Tajikistan, reflecting specific features of pledge relationships using securities. While the current civil legislation of the Republic of Tajikistan recognizes securities as a valid collateral, most regulations covering pledge relations are constructed in such a way that they reflect features of using tangible goods as collateral. Fragmented and unfinished nature of legal regulation of the relationships arising from pledge of securities gives rise to hard-to-solve problems in banking practice that are related to concluding the securities pledge contract, determining commencement of lien in the securities pledge, execution of rights covered by the pledged securities, forfeiture of the pledged securities.

Keywords—pledging of securities; method of enforcement of liabilities; loan liabilities; share; bond; debt security

I. INTRODUCTION

The institute of credit plays an important role in the modern market-based economy, as it facilitates resolving the problem of limited financial resources. By means of credit resources, business entities have a great possibility to cover their personal and business needs and speed up achievement of business goals. Being a source of financing for various economic measures, credit is an important factor of stability of the state monetary policy and facilitates improvement of economic situation in society. Due to this, there is a stable loan growth trend in various industries of the Republic of Tajikistan.

However, development of the loan policy is closely intertwined with the problem of default on loan, which is a real threat not only for financial situation of an individual credit organization, but for the economic system of the state as a whole. Today in Tajikistan, almost all commercial banks encounter the problem of default on previously granted loans; economic result of this situation is a real threat for bank smashup.

To solve this problem and regulate credit relations there is a need in improvement of legal mechanisms that protect the interests of the owners of the loan fund capital. There, the

major role is played by pledging as an institute ensuring collectibility through the mechanism of tangible security

Pledge always took an important place among the enforcement measures used by participants of any contractual relations. As S.L. Sitnikov aptly notes, "the very stability of relations arising in the stream of commerce directly depends not only on whether the contracting parties duly perform their assumed obligations, but to what extent and in what way the possibility of protection in case of failure to perform or improper performance of obligations on behalf of an unprincipled party is implemented" [1]. Commercial banks and other credit organizations feel the veracious nature of this statement in their daily activities more than any other participants in the stream of commerce do, and thus aspire to reduce the credit risk with the help of various legally set up methods of security.

Various aspects of the problem have been previously analyzed by several researchers [2-6]

II. RESULTS AND DISCUSSION

Pledging takes a special place among security measures used in banking practice, as it is the most reliable and efficient method to ensure credit repayment that provides commercial banks with actual possibilities for fulfilling the loan liabilities. The institute of pledge is intended to remove or at least minimize the elements of unjustified risk characteristic of credit relationships. Legal literature also notices a service role of bail bonds in bank loans that broadly speaking lies in facilitating stability of the stream of commerce and banking system. Nowadays, this role is especially in demand, as the default on credit has become a mass phenomenon. In this meaning, the modern legislation on pledge is one of the components in the general regulative strategy for banking reform of the modern states. Narrowly defined, the service role of liens in bank lending is limited to enforcing fulfillment of liabilities resulting from a given loan agreement [7].

A close relationship between the loan and pledging relations is known to the civil law studies since the times of Roman Civil Law, where pledge was directly linked to a loan agreement [8]. The modern legislation, while not linking pledging exclusively with the loan, nevertheless sees the interrelation between the credit and pledge relationships. For example, in Article 3 of the Law of the Republic of Tajikistan On Banking Activities [9], pledge is assumed as one of the

main method to ensure bank credit recovery. The same conclusion follows from the provisions of the Instruction no. 186 *On Procedure of Providing Credit and Interest Calculation in Credit Organizations*, approved by Decision of Administration of the National Bank of Tajikistan on October 17, 2012, no. 255, registered with the Ministry of Justice of the Republic of Tajikistan on November 26, 2012 no. 612 “a” (Chapter 4, 6 of the Instruction) [10].

Loans to credit organization used by the National Bank of Tajikistan as a tool of monetary credit policy are also provided against pledging of securities or other assets. Other security methods for loans issued by the National Bank of Tajikistan (such as guaranty and bank bond) are not named directly by the legislators among the security means (Article 21, 22 Law of the RT On National Bank of Tajikistan [11].

Such preference has a good reason. It is hard to overestimate the advantages that pledge has over other security means. First, it should be noted that performance of liabilities covered by the pledge is by foreclosure of pledged assets, thus dependence of creditor on the personality of debtor or guarantor is removed. Pledge is the only security means that has estate nature. Compared to fines, downpayment, guaranty and bank bond, in all these cases the creditor trusts the person of debtor or that of the person taking on themselves the responsibility for debtor's performance of obligations. This is also noted by M.E. Poskrebnev, who points to pledge as protective means for creditor interest, stimulating the debtor to fulfill the main liability and not depending on external conditions subject to change, compared to a fine which directly depends on financial situation of the debtor in the moment of their failure to fulfill the main liability, or compared to guaranty that depends on well-being of the guarantor that may deteriorate by the moment basis for fulfilling creditor's demand may arise [12].

Estate nature of pledge determines another characteristic of pledge: resale right. The resale right is enshrined in Part 1 Article 382 of the Civil Code of the RT [13], provisions of which state that in case of change of ownership of the pledged asset or if the right of economic jurisdiction is transferred from pledgor as a result of alienation for compensation or without compensation to another person, or under the law of succession, the right of pledge is still valid. The successor stands in place of the pledgor and bears all the liabilities of the pledgor, unless their agreement with the pledge holder states otherwise. This rule means that whoever owns the pledged item, this item still bears charges until the main liabilities are fulfilled, that is the right of pledge is valid. This is because the right of pledge is not with the person of the pledgor, but with the pledged item.

If the pledgor's pledged property came over to several persons according to the law of succession, then each of the successors (acquiring party) bears a part of pledge-related liabilities corresponding to their part of the acquired pledged property. In case of indivisible item, or when due to other justification the pledged item stays in the common property of successors, they become joint pledgors (Part 2 Article 382 of the Civil Code of the RT).

Second, pledge allows protecting the interests of the creditor from inflation processes, as the price of pledged item usually grows proportionally to the level of inflation, thus providing preservation of the pledged item to the moment of settling of accounts between the debtor and the creditor.

Third, the natural properties of the pledge allows the pledge holder creditor to fulfill their demands in priority to other creditors by means of the pledged item. However, it should be noted that this priority is not absolute. This is pointed out in provisions of Article 65 of the Civil Code of the RT, where the following sequence of fulfilling the creditor demands is given. At first instance, the demands of the citizens to whom the legal entity being dissolved is liable for causing harm to life and health are fulfilled by means of capitalizing relevant regular payments. At second instance, separation allowances and salaries are paid to persons working under labor contracts, including contractors, and copyright agreement fees are paid. At third instance, such demands of creditors are fulfilled where liabilities are secured by pledged property of the dissolved legal entity. At fourth instance, tax liabilities are redeemed. Finally, at fifth instance, demands of other creditors are fulfilled in accordance with the law.

The following advantage has a psychological origin. As N.I. Braginsky notes, a real possibility of losing pledged item that is usually very valuable and a quick asset serves as a good stimulus for the debtor to fulfill their liabilities properly [14].

The noted advantages of the institute of pledge, undoubtedly, support its reliability in covering the interests of creditor with respect to the main liability, especially at the current stage of development of the Tajik economy that is characterized by still insufficient stability of the stream of commerce. Besides, application of the institute of pledge allows reviving moral and ethical aspects of relationships of persons participating in the stream of commerce, providing contract security with the attribute of being mandatory, thus, in its own turn, strengthening the significance of the *clear consciousness* concept stated by the Civil Code of the RT and creates more trustful relationships between the participants in the civil relationships. In the end, all this translates into recognizing the institute of pledge in law enforcement practice and its corresponding development, leading, according to D.I. Meyer, to weakening in application of other means of enforcing the liabilities that thus become “superfluous, or, at least, rarer” [15].

Pledge of securities recently has some expansion among other types of pledging used in banking.

Considering pledge as an integral part of the credit process and the most efficient way for enforcing the loan liabilities, the Republic of Tajikistan actively pursues policy of developing the pledge relationships, setting the goal to develop new loan types, including with pledging of securities. In particular, it was noted back in the Strategy for Development of Securities Market in the RT for 2008-2012, approved by Decree of the Government of the RT on April 1, 2008, no. 169 [16]. Assessment of Main Directions in Monetary and Credit Policy of the Republic of Tajikistan for 2006, approved by the Degree of the Government of the RT on December 2, 2005, no. 450 [17] names the immaturity of

the legislative framework concerning pledging among the obstacle for development of provision of loans to entrepreneurs.

For credit organizations, using securities as pledged items is becoming a necessary task in the Plan of Measures to Develop the Secondary Security Market and Stock Exchange in the Republic of Tajikistan, approved by the Decree of the Government of the RT on September 25, 2015, no 589 [18]. In the Mid-Term Strategy for Development of the Banking System of the Republic of Tajikistan, approved by the Decree of the Government of the Republic of Tajikistan on August 3, 2007, no. 414, unresolved nature of a number of key issues in pledge-related legislation is deemed as a factor obstructing achieving stable development of the national banking sector [19].

It is no secret that in many states securities are actively used in formalizing the credit relationships, while pledging of securities is assumed being an efficient method for enforcing the liabilities, while in Tajikistan, it is only recently that some measures have been taken to completely unlock potential of this type of pledge.

Meanwhile, pledging of securities may have a significant economic importance for improvement of the monetary and credit policy of the state and development of Tajik banking system. The duly functioning pledging of securities may become an important legal tool, facilitating solution of the problem of credit recovery in the area of bank loans

Pledge of securities has a number of advantages compared with pledge of other properties.

First, pledged securities are highly liquid assets (easily realized in the securities market), thus maximally lowering the risk of default on credit.

Second, expenses due to storage of certificated securities and accounting of book-entry securities are relatively low.

Third, stock exchange listing allows creditor to have an objective evaluation of the pledged item.

Fourth, if the securities are profitable, then, as agreed by parties, this profit may be used for debt service.

Fifth, if the pledged item comes over to the ownership of the bank, the securities may be retained for investment portfolio of the bank itself.

Due to such advantages, there is currently increased interest to operations concerning pledge of securities on behalf of the commercial banks.

However, despite such advantages, pledge of securities is the most complicated one, both theoretically and practically. The first complication of this type of collateral is related to a lack of special provisions in the current legislation of the Republic of Tajikistan reflecting specific features of pledge relationships that use securities. The Civil Code of the RT, when defining the kinds of property that can be pledged includes a reference regulation for the securities, according to which pledging of securities of joint stock societies, including other banks and other businesses is to be performed in

accordance with the legislation on securities (item 5 Article 360 of the Civil Code of the RT). Besides this reference regulation, the Civil Code of the RT contains another mention of pledge of securities: item 4 Article 367 of the Code establishes that pledge of property rights certified with a security is performed by transferring the securities to pledge holder or to a notary deposit unless otherwise stipulated by the agreement.

Speaking of special legislation, the Law of the RT *On Pledge of Movable Assets* dated March 01, 2005, no 93 also has very few regulations covering pledge of securities. There are only two of them: in Article 4, the law lists securities among movable assets that may serve as pledge items; Article 21 highlights that recording of pledges involving corporate securities shall be performed by authorized bodies (security registers) [20].

Analysis of provisions of the above mentioned law shows that it has no special regulations to reflect specific features of pledging of securities. Most of its regulations are structured in such a way that they take into account advantages of tangible goods as pledge items, but not securities.

In addition to the Law of the RT *On Pledge of Movable Assets*, some issues related to pledge of securities are regulated by the Law of the RT *On Joint Stock Companies*. In particular, according to provisions of Article 42 of the Law, making an entry in the shareholder register to establish pledging and termination of pledging of shares shall be performed on request of the shareholder or nominee holder in three days since provision of supporting documents. According to item 4 Article 56 of the Law, voting with the pledged shares is performed in accordance with the terms and conditions of the pledging contract, unless otherwise provided by the law [21].

In addition to laws, there are also some subordinate legislation intended to regulate pledge relationships. Among them we may name the Decree of the Government of the RT *On State Registration of Pledge Contracts*, dated August 6, 1999, no. 365, where the responsibility for state registration of the pledge contracts is vested with the Ministry of Justice of the Republic of Tajikistan and its local bodies. In addition to this Decree, there is an Instruction *On Procedure of Recording Pledge of Movable Assets and Unified State Register of Pledges*, approved by the Ministry of Justice of the RT on March 9, 2006, no. 32 on the basis of Article 21 of the Law of the RT *On Pledge of Movable Assets*. The Instruction defines the registration procedure for pledge of movable assets [22].

Rules, Instructions and Provisions of the National Bank of Tajikistan are among the most important legal sources of the right of pledge: *Rules for Provision of Credit to Credit Organizations on Behalf of the National Bank of Tajikistan in Case of Emergency* dated 02. 08. 2012, no 166; Instruction no. 199 *On Provision of Microcredit and Microcredit Organizations*, dated 07.05.2014; Provision no. 110 *On Lombard Lending*, approved by Management of the National Bank of Tajikistan on 09.02.2001 [23-25].

III. CONCLUSION

Thus, while the current civil legislation of the Republic of Tajikistan recognizes securities as a valid collateral, most of regulations covering pledge relations are constructed in such a way that they reflect features of using tangible goods as collateral.

Fragmented and unfinished nature of legal regulation of the relationships arising from pledging of securities gives rise to hard-to-solve problems in banking practice that are related to concluding the securities pledge contract, determining the initial moment of the securities pledge, execution of rights covered by the pledged securities, forfeiture of the pledged securities.

Moreover, securities include a wide range of documents: shares, bonds, debt security, certificate of deposit, savings certificates, consignment note, warehouse warrants, etc. Each of these types of securities has specific features due to the economic and legal specificity of rights that they certify. Different legal status depends on whether the security is issue or non-issue, registered or bearer security, certified or book-entry, corporate or government. Correspondingly, pledge relationships that use securities shall reflect the features of the respective securities.

As a result, such incompleteness of legal regulation of pledge of securities limits application of this type of pledge in banking practice. Due to this, there is an evident need for development of legal regulation for legal relationships arising due to pledge of securities.

Insufficiency of legal regulation is aggravated with economic problems that Tajikistan is facing, inflation processes, lack of organized security market. Due to all this factors, commercial banks do not provide long-term loans against pledge of securities. Indeed, provision of long-term loans against pledge of securities is related to a significant risk for the bank, as during the period of the loan agreement the market value of the pledged securities may significantly change to devaluation, thus the bank will take losses due to market evaluation change in case of default on the loan. That is why, practice of foreign commercial banks operating with long-term loans against securities includes many additional provisions protecting the rights of the bank in case of changing market evaluation of the securities. However, provision of such loans is in any case determined by availability of long-term credit resources, which is out of reach of the Tajik commercial banks under current conditions. Thus, currently we may see mainly short-term loans against securities in the banking practice.

According to the general rule, various securities (shares, bonds, certificates of deposit and other securities) may serve as pledged item. However, for a certain security to be worthy of creditor's attention as collateral, it is necessary that it is of financial interest to them as an efficient way of enforcing loan repayment and actual possibilities for fulfillment of loan liabilities. For whatever is the degree of reliability of the collateral, taking it as a pledged item invariably imposes a number of specific risk onto the commercial bank.

In this context, only securities having a pledge value are usually taken as collateral for commercial bank credit liabilities.

Thus, pledge relationships involving pledge of securities are characterized by certain features related to the legal nature of the securities as specific objects of the civil law, including elements of estate and liability content.

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