

PARTIAL CREDIT GUARANTEES: PRINCIPLES AND PRACTICE

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Direct and directed lending programs are in eclipse

Government-backed partial credit guarantee has become

the **direct intervention mechanism of choice** for SME credit activists.

2000 schemes in 100 countries (Green, 2003).

- Almost all OECD countries
- All of the multilateral development banks

Usually targeted at:

some sector, region or category of firm or individual
thought to be underserved by the private financial sector.

e.g. **SMEs, young or new technology firms**

(or those hit by an adverse shock and risk failure).

Often there is a subsidiary

employment, innovation or productivity growth objective.

It is clear that **market failure exists for SME lending**

A well-designed and well-targeted policy intervention *might* improve welfare.

But the growth in publicly funded partial credit guarantees reflects more:
... the **disappointing experience of other forms of intervention** than
... any substantial body of evidence that such schemes work well.

It is often **unclear what the precise goals** of these schemes are...
...makes **cost-benefit analysis highly problematic**.

Guarantee schemes offer several features that are seductive for politicians and administrators.

In all of these dimensions guarantee schemes **politically** outperform direct government lending programs.

So: heightened vulnerability of credit guarantee schemes to opportunistic or self-serving politicians

Nevertheless they do offer **some advantages over direct govt. lending.**

- The **risk-sharing** element with profit-oriented intermediary banks generates an independent creditworthiness hurdle for borrowers,
- And can also help bring **transparency** inasmuch as the intermediaries are aware of the loan-loss experience.
- By outsourcing the origination and servicing of the loan to a for-profit intermediary, **operational efficiency** may be improved.

Why the market uses credit guarantees

Credit guarantees are observed in private financial markets without explicit government support, as do their close cousins, credit derivatives.

They emerge typically for one of three main reasons.

- **Differential information**, as where the borrower's creditworthiness is better known by a well-capitalized guarantor than by the lender. Mutual guarantee associations provide an illustration here, as does the guaranteeing of a supplier's borrowing by the purchaser.
- **Spreading and diversifying risk**, for example where the lender's portfolio is geographically concentrated, but the guarantor has a diversified portfolio.

- **Regulatory arbitrage.** This can occur when an unregulated firm provides a guarantee allowing the lender to bring an otherwise insufficiently secured loan into compliance with regulatory requirements or other government programs or financial industry risk-rating practices and conventions. Or to evade interest ceilings

Motivation for government involvement

It is less clear what specific market failure causes *guarantees* to be undersupplied (as distinct from credit in general).

(a) *Social welfare*

SMEs commonly do not have the kinds of **collateral** required by bankers (begs the question whether the resulting change in credit allocation improves overall welfare).

NB: a third-party guarantee is **not a perfect substitute** for collateral (which provides a signal of information and intent & is a deterrent to moral hazard, cf. Besanko and Thakor, 1987).

Banking reliance on collateral tilts the incentive for borrowers towards acquiring machinery – this **bias avoided** by third-party guarantee.

Partial credit guarantee does have the clear potential advantage of **sharing the credit risk** and (partially) **outsourcing credit appraisal** to an independent risk-taker.

But the government needs to be sure that such a scheme will increase overall welfare by enough to **justify the subsidy cost**, and not simply result in a costly distortion.

A welfare economics perspective suggests three possible sources of from which a net welfare improvement could come:

- Market failure related to **adverse selection**.
- Correcting for **unequally distributed endowments**.
- Exploiting **externalities** from the entrepreneurial dynamism of under-resourced entrepreneurs.
- **Kick-starting** SME lending.

(b) *Public choice*

Guarantee schemes features seductive for politicians & administrators.

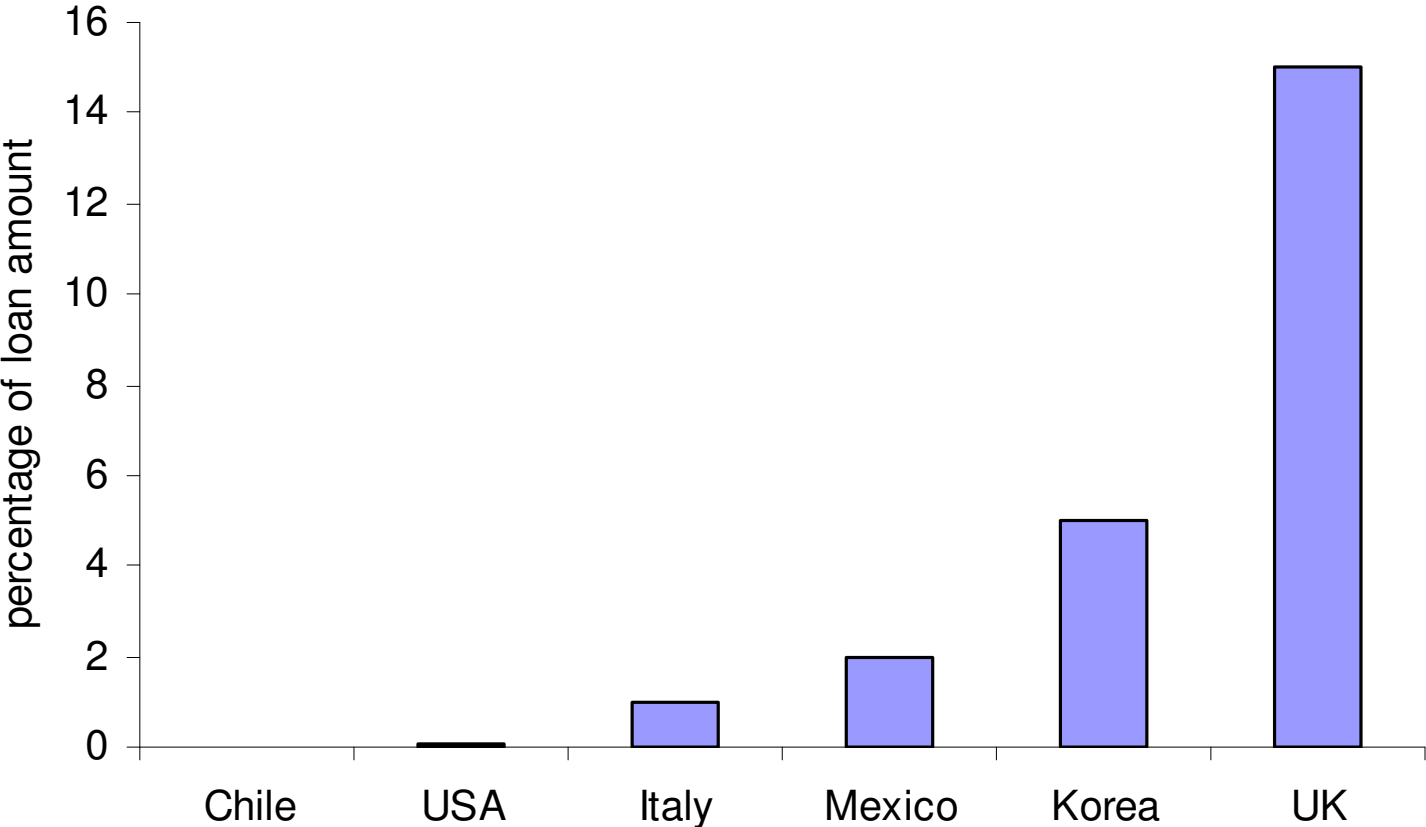
- The **evident market failures** that exist in small business finance.
- The family resemblance that guarantees bear to market-based institutions which gives them an **unwarranted public legitimacy**
- Overoptimistic pricing and blurred accounting can **conceal the true fiscal cost of schemes** for a politically-sufficient duration.
- Relatively small cash outlays (at least initially) can **leverage** large numbers of loans and volumes of lending for which the political system can take credit.

Scheme costs (some examples)

- FOGAPE (Chile): annual charge of 1 to 2 per cent of the loan amount (depending on the claims performance of participating banks) covers administrative expenses plus claims (Benavente et al. 2006; Bennett et al., 2005; De la Torre, Gozzi, and Schmukler, 2007).
- US: SBA Section 7a program, equivalent to a *one-time* subsidy of only about 1.3% of the value of the guaranteed loans (including provision for calls on the guarantee and operating expenses). This works out at about 0.1% per annum of the outstanding stock of guaranteed loans, given the average maturity of 13 years (US GAO, 1996). US Student Loan Guarantees are much more costly, about 1.5% per annum – Lucas and Moore, 2008
- Italy SGS: annual subsidy grew to about 1 per cent by 2004 (Zecchini and Ventura, 2006).

- The charges of between 0.5 and 4 per cent of the sum guaranteed made by Mexican schemes cover only about a half of the operating costs and underwriting losses (Benavides and Huidobro, 2005).
- Korean KCGF charges between 0.5 per cent and 2 per cent depending on the borrower's credit rating, with an average of just over 1 per cent, covers only a fifth of the scheme's outlays. The two big Korean schemes lost almost 4 per cent per annum of the stock of outstanding guarantees in 2001-5 (Shim, 2006).
- Over the years, the UK SFLG scheme—which charges an annual 2 per cent fee—experienced defaults on more than one in three of its guaranteed loans; requiring a subsidy amounting in a recent year to 15 per cent of gross new guarantees in that year (Graham, 2004).

Average annual subsidy: % of outstanding loans



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In some cases, we know composition of loss experience by size of firm.
Big costs more (Canada)

Thus, while numerous schemes have experienced much higher than expected losses, **heavy and unanticipated underwriting costs is by no means a universal experience of credit guarantee schemes** (Doran and Levitsky, 1997; Bennett et al. 2005),

On the other hand, the cost of losses is **not necessarily skewed towards the smallest borrowers.**

Measuring benefits

(a) *Additionality*

Most evaluations rely on the **qualitative assessment** of bankers and SME insiders or on only **moderately convincing imputations**:

Riding and Haines (2001) note that less than 5% of total bank loans are to “young firms”, i.e. those less than 1 year old, the fact that over 14 per cent of guaranteed loans under the Canadian SBLA scheme are to “young firms” implies additionality of at least the 9 per cent differential.

For the Philippines, Saldana (2003) estimated additionality by counting only those loans for which bankers held amounts of collateral that fell short of total loan value.

Riding, Madill and Haines (2007) estimated a loan denial function on data for Canadian loan applicants that were *not* eligible for the loan guarantee scheme; they use this to predict how many of those firms that successfully applied under the scheme would otherwise have been denied.

By distinguishing between the experience of Chilean firms whose main bank began using the FOGAPE scheme at different times, Larraín and Quiroz (2006) estimated that microfirms whose bank used the FOGAPE scheme had a 14 per cent higher probability of getting a loan.

(b) Factors other than additionality

Even if there is additionality, it might involve such heavy **loan losses or other costs** as to result in net welfare losses for the economy as a whole.

Spillover effects of additional lending attributable to the scheme do need to be taken into account.

(A macro approach to spillovers is illustrated by Craig, Jackson and Thompson, 2007, who use US regional data to detect any differential employment growth in areas which have disproportionately benefited from SBA-guaranteed lending).

If true goals are

- (i) kick-starting market capacity for SME lending (time-bound) and
- (ii) energizing entrepreneurs now excluded because of lack of collateral in the hope of generating dynamic medium-term externalities not easily captured by the market (long-term)

Then **data effort should measure the relevant benefits** for appraisal.

- Thus, for the kick-starting goal, one would seek measures of increasing willingness of banks to make SME loans autonomously.
- For the excluded entrepreneurs goal, even additionality in loans would not be counted as a benefit if it went to recipients other than the defined target group.
(cf. Nitani and Riding, 2005: Japanese schemes emphasized rescue rather than start-up or expansion situations.)

Operational design

Should scheme do its own *credit appraisal* of final borrowers?

- Too costly; no information advantage
- Penalize lenders *ex post* with high claims instead

What *rate of guarantee*?

70-80% the norm – should be no higher and possibly lower

Could differentiate rates according to assessed risk

Or auction available amounts with bids on the cover rate (Chile)

What *lending criteria*?

Trend to broader

US-type criterion unenforceable?

Complex criteria costly & prone to corruption,
but without them more deadweight

Concluding remarks

Credit guarantees have a natural place in the market.

Where they are not sufficiently forthcoming, there may be welfare improvements from well-designed government-sponsored schemes

- **carefully targeted** on currently excluded SME entrepreneurs and
- with **dynamic incentives** for market-based lenders to acquire skills.

Such schemes will, however, **never substitute for** reform of the underlying **institutional requirements** of an effective credit system.

- Further, guarantee schemes with large but hidden costs may be introduced mainly because of their **political attractions**.
- The social welfare benefits are often **vague and little studied**.
- Scheme design has varied widely and **few schemes build-in** promising and readily available **incentive structures**.

To overcome the hazards of short-termist policy there should be:

- (i) **clearly defined**, precise and coherent welfare improvement **goals**;
- (ii) a reliable and **realistic** approach to **accounting** so that costs can become evident early;
- (iii) **built-in data collection** allowing prompt evaluation of outcomes;
- (iv) **attention to scheme design** that maximizes the chance of successful goal achievement.