



## Partial credit guarantees: Principles and practice<sup>☆</sup>

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### ABSTRACT

Partial credit guarantee schemes have experienced renewed interest from governments keen to promote financial access for small enterprises, not least as a response to the credit crunch in advanced economies. While the market can find uses for partial credit guarantees, the attractions for public policy can be illusory: indeed their most attractive feature for myopic politicians may be the ease with which the true cost of guarantees can be understated, at least at the outset. In practice, the actual fiscal cost of existing schemes has varied widely across countries and has represented a high per dollar subsidy in some cases. Despite the recent application of some innovative techniques, the social benefit of such schemes has proved difficult to estimate, not least because their goals have been vague. Operational design has influenced the cost and apparent effectiveness of different schemes and has also varied widely. Clear and precise goals, against which performance is regularly monitored, realistic pricing verified by consistent and transparent accounting, and attention to the incentive features of operational design, especially for the intermediaries, are among the prerequisites for such schemes to have a good chance of truly achieving improvements in social welfare.

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### 1. Introduction

With direct and directed lending programs somewhat in eclipse in recent years, the direct intervention mechanism of choice for Small and Medium Enterprise (SME) credit activists in recent years has been the government-backed partial credit guarantee.

According to Green (2003), well over 2000 such schemes exist in almost 100 countries. Thus more than half of all countries – and all but a handful of the OECD countries – have some form of credit guarantee scheme, usually targeted at some sector, region or category of firm or individual which is thought to be underserved by the private financial sector. In addition, all of the multilateral development banks have guarantee schemes as well as loans and other instruments. Such schemes seek to expand availability of credit to SMEs, sometimes focused on specific sectors, regions or ownership groups, or on young or new technology firms (or even on firms that have been hit by an adverse shock and risk failure). Often there is a subsidiary employment, innovation or productivity growth objective. The scale of these schemes varies widely, with Asia having

the largest schemes—with outstanding guarantees amounting to an average of 5% in the six Asian countries included in the survey by Beck et al. (2008).

The upward trend likely reflects more the disappointing experience of other forms of intervention than any substantial body of evidence that publicly funded partial credit guarantee schemes work well. Indeed, as has been remarked by numerous commentators, it is often unclear what the precise goals of these schemes are, which makes cost-benefit analysis highly problematic.

Reflecting the deepening financial crisis in mature financial systems, and the drying-up of credit, there has been a raft of new partial guarantee announcements from Governments since September 2008. In many cases these new schemes are, at the time of writing only at the design stage, or have just begun operation.<sup>1</sup>

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<sup>1</sup> Many of the guarantee schemes recently announced are in quite different categories to that being considered here. Some guarantee bank depositors, or even investors, as with the special temporary guarantee program for investors in money market mutual funds announced by the US Treasury in late September 2008. Government agencies in the US, UK, Germany and elsewhere have been offering to guarantee interbank and other borrowings by banks many countries from October 2008. And the guarantee against exceptional losses given by the US Treasury to Citigroup as part of its rescue package in November 2008 relates to an existing block of securities, rather than covering new lending; the same is true of one of the large schemes announced for British banks in January 2009. Finally some of the guarantee schemes are aimed at large firms, such as the German scheme availed of by Volkswagen in late 2008.

Setting the scene for this special issue on partial credit guarantees, this paper argues that guarantee schemes offer several features that are seductive for politicians and administrators. The family resemblance that they bear to market-based institutions gives them an unwarranted public legitimacy, as do the evident market failures that exist in small business finance. 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. In all of these dimensions guarantee schemes politically outperform direct government lending programs.

Despite this heightened vulnerability of credit guarantee schemes to opportunistic or self-serving politicians, they can offer genuine advantages over direct government 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. Besides, it is clear that market failure exists for SME lending and a well-designed and well-targeted policy intervention *might* improve welfare.

Against that background, we begin (Section 2) by asking what the point of a loan guarantee is, pointing to the potential roles of differential information, risk-spreading and regulatory arbitrage in inducing the emergence of for-profit provision of such guarantees in the market. Section 3 turns to the diverse motivations for having government-sponsored schemes, considering both social welfare goals and the private interest of policymakers (public choice theory). We proceed to review evidence on the costs of existing schemes (Section 4), noting the very wide range of outcomes that have been experienced worldwide. The literature has begun to respond to earlier complaints about the paucity and lack of robustness of most cost-benefit studies in this area. The challenge of obtaining good benefit estimates remains, however, as we discuss in Section 5. The effectiveness of guarantee schemes in mobilizing the resources and skills of market intermediaries, and the likely benefit outcomes are considerably dependent on operational design (Section 6). Concluding remarks are in Section 7. We focus on guarantees for small business/small enterprise lending and in particular say little about programmes focused on guaranteeing exports credits against purchaser default.<sup>2</sup>

## 2. Why the market uses credit guarantees

Of course, 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.

- First, because of differential information, as where the borrower's creditworthiness is better known by a well-capitalized guarantor than by the lender. The operation of mutual guarantee associations provides an illustration here,<sup>3</sup>

<sup>2</sup> With their focus on the creditworthiness of foreign customers, including political risk, their wider diplomatic and political goals, and their potential importance, where subsidized, as distortions of trade, export credit guarantees raise additional questions not treated here (cf. Stephens, 1999; Auboin and Meier-Ewert, 2004).

<sup>3</sup> Cf. Columba et al. (2008) who provide a detailed analysis of the extensive network of Italian Mutual Guarantee Consortia. According to their analysis, based on extensive data on individual loans from the official Italian credit register, the peer monitoring and enhanced mutual information of the members of these consortia (which are typically based on industry associations) allow their members to negoti-

as does the guaranteeing of a supplier's borrowing by the purchaser.

- Second, as a means of spreading and diversifying risk, for example where the lender's portfolio is geographically concentrated, but the guarantor has a diversified portfolio.
- Third, as a 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 (as in US mortgage insurance<sup>4</sup>). Another important case of regulatory arbitrage is when the guarantee premium is used to bring the total servicing charge for the loan above a regulated ceiling on lending interest rates and thus closer to a market-determined interest rate.<sup>5</sup>

It will be obvious that the second and third motivation have also been given as reasons for the development of mortgage and other asset-backed securities. However, when the originators of mortgage loans and other loans packaged into such securities did not retain any of the risk, it is clear that the first motivation did not apply in that market and for those instruments.

This paper focuses on *partial* credit guarantees, i.e. where the lender retains some of the risk. There are many variants, starting with the *pari passu*, where lender and guarantor each absorb a fixed fraction of any loss, and the *first-loss*, where the guarantor pays out on all of the loss up to some fixed fraction of the total loan obligation. Each has different incentive features and costs.

## 3. Motivation for government involvement

It is less clear what specific market failure causes *guarantees* to be undersupplied (as distinct from credit in general). Undersupply of credit generally could come from information problems resulting in equilibrium credit rationing as discussed in the famous model of Stiglitz and Weiss (1981). It does seem clear that lack of credit is a binding constraint on enterprise and SME investment, most strikingly illustrated by the increased enterprise and very high returns achieved by persons endowed or gifted with additional capital sums (cf. Blanchflower and Oswald, 1998; de Mel et al., 2008).

### 3.1. (a) Social welfare

Government involvement in creating a credit guarantee company is often rationalized by the observation that SMEs commonly do not have the kinds of collateral that are required by bankers. Of course this statement just describes the dimension along which the credit guarantee operates to alter the allocation of credit. It begs the question whether the resulting change in credit allocation improves overall welfare.

ate lower lending rates (by about 20 basis points) on otherwise uncollateralized loans from the banks, without incurring a net loss on the guarantee operation: indeed, membership of a consortium is clearly associated with lower default rates, especially in the South of Italy where creditworthiness information is otherwise not easily available. The effectiveness of these consortia appear to be increasing in size up to about 8500 firms.

<sup>4</sup> Regulatory requirements constraining some lenders from making uninsured mortgage loans with a loan-to-value (LTV) ratio above 80% has strengthened the private mortgage insurance (PMI) market in the United States, which, thanks to market conventions, also helps ensure high credit ratings and thus lower yields for bonds backed by high LTV mortgages that are not insured by Federal Agencies (Green and Wachter, 2005).

<sup>5</sup> There have been suggestions that this mechanism has underpinned the rapid growth in guarantee schemes in China in the last decade or so.

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