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Credit Guarantee Schemes in Small and Microenterprise Finance: Do they really do more good than harm? - The Case of the Philippines -

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1. General review

In developing countries, the vast majority of small enterprises start their operations without any institutional help. However, they find it difficult to grow without access to credit. Restrictions in access stem from high perceived risks involved, lack of information, high transaction costs, lack of track record, lack of adequate documentation and book-keeping, plus ignorance and prejudice. Governments and donors have attempted to overcome some of these problems by providing credit and credit guarantees, both subsidized and targeted. Credit guarantee schemes typically emerge as a complement to direct credit or as an incentive in commercial lending to enterprises without sufficient collateral or track record. Both are forms of social banking which do not rest on banks' commercial interests alone. As access to central bank rediscounting facilities is not found sufficient to motivate banks to lend to the small enterprise sector, credit guarantee schemes are added as an additional incentive. They are supposed to overcome collateral problems, which are believed to be a crucial impediment.

Banks take what they can get, be it subsidies or credit guarantees. Yet none appears to be a major motivating force in lending decisions, least so among dynamic banks. These prefer to select their own clients and do banking by criteria of their own rather than of government. "A guarantee scheme does not make me decide to lend," says A. V. Buenaventura (3), president and manager of the Rural Bank of Panabo, Philippines. Similarly, Northern Mindanao Development Bank (NMDB) in Cagayan de Oro, while usually insisting on collateral, lends to the informal sector regardless of credit guarantees.

Credit guarantee schemes are found particularly harmful when combined with interest rate ceilings, forced grouping of beneficiaries and production targets. There are cases where credit guarantee schemes work contrary to the purpose for which they have been set up. Instead of motivating banks to extend its small enterprise lending portfolio, the overall effect is rather to restrict lending to those enterprises for which credit guarantees are available and exclude all others. It is not uncommon that boards of directors, removed from daily operations as they are, require their managers to restrict lending to the limits set by credit guarantee funds - assuming that given their internationally favored treatment, they must be essential in lending.

An example from Africa is the linkage banking program of the Central Bank of Nigeria (CBN) along the lines of a model of linking formal and informal financial institutions as first published in this journal (10). Coverage under the Agricultural Credit Guarantee Scheme Fund (ACGSF) enticed banks to limit their lending to beneficiaries of ACGSF for purely agricultural purposes at subsidized rates with ceilings as stipulated by ACGSF, thereby extending remnants of previous regulatory policies into the deregulation period, 1986 - 93. This has undermined the viability of rural banking and restricted the growth of the program (13). In contrast, a similar program under the Central Bank of Indonesia relying on group solidarity without credit guarantees led to no such restrictions and was enthusiastically embraced by banks and clients (14). On a broader scale, during the 15-year period from its operational inception in 1978 to 6/1993, ACGSF in Nigeria guaranteed a cumulative total of 169,312 loans (4). By comparison, during the seven-year period from its start in 1984 to 12/1990 nonguaranteed small loans currently outstanding by Bank Rakyat Indonesia grew from zero to 1.9 million and were, at the end of that period, completely financed from village-level savings mobilization (11).

Among the unwanted and undesirable effects of credit guarantee schemes are, laxity in client selection, reductions in the enforcement of repayment, increased project complexity, increased hidden transaction costs for banks and borrowers, delays in disbursement, moral hazard, and mistrust between fund holder and bank. Business-minded bank managers therefore shy away from credit guarantees as they put the wrong ideas in the heads of the wrong customers. Guarantee-induced forms of social banking are not conducive to market-oriented lending and investment. Banks which end up with claims on the credit guarantee fund frequently find their name ruined and their staff's attitude spoiled. Hundreds of banks in the Philippines - particularly rural banks - are bankrupt: as a result of social banking, i. e. lending guaranteed subsidized funds to priority sectors.

Credit guarantees may either be a substitute for collateral, or in some cases, a security of last resort, in addition to collateral. There are five major types of guarantee arrangements: government-funded schemes; schemes operated by NGOs; corporate entities jointly funded by the beneficiaries; and joint-and-several liability groups. The first three are usually donor or government-driven, the latter two beneficiary-driven. It is only in the last category where members are fully liable for each other's debts. In all other categories liability, to the extent defined by the loan and the liability contract, is transferred to a fund as a separate legal entity. The prevalent arrangement in Germany is that of credit guarantee communities ("Kreditgarantiegemeinschaften") set up during the 1950s along sectoral lines jointly by chambers, state (*Länder*) governments and saving banks; they are now merging into credit guarantee banks ("Bürgschaftsbanken"), one for each state.

Corporate credit guarantee schemes require initial capital, provided by their owners and perhaps a donor, and regular income to cover running costs and losses. Income on investment may be used to increase the fund or to offset losses. Running expenses

and losses from defaults should be, but rarely are, covered from the payment of a fee or a premium. There are numerous ways of calculating the fee, but the most equitable arrangement is the payment of a small front-end payment and an annual fee on the remaining guaranteed balance. Losses beyond a certain level may be covered by reinsurance.

In their review of credit guarantees in developed and underdeveloped countries, Levitsky & Prasad (7) found a strong predominance of publicly funded schemes; a low coverage rate mostly ranging from below 1 % to about 5 % of small enterprise loans; high losses in many countries, depending in magnitude on the "risk frontier" and on the professionalism of the institutions involved; and little if any additionality. Only mutual guarantee associations of restricted membership were found in both developed and developing countries to usually have a good performance record, but with a minute overall impact on the total volume of small enterprise lending. They recommended credit guarantee schemes as a useful financial instrument to compensate for market imperfections, but only on the condition that they are operated with a business approach and aim at financial self-sufficiency, with the government, the business community and banks all assuming some part of the risk. Furthermore, credit guarantees should not be extended to projects of doubtful viability; and the lender should not eliminate personal guarantees or collateral because of the availability of guarantee funds.

With reference to its experience with a combined small enterprise loan and guarantee fund in Kenya, the Friedrich Ebert Foundation, itself an NGO (6; p. 2) recommends to work "through established professional financial institutions, not NGO's" and emphasizes the crucial importance of guidance, training and monitoring.

Schmidt (9), at a joint conference of GTZ and the Development Bank of Zambia, reported that credit guarantee funds have serious operational problems. They create moral hazard, suffer from adverse selection, produce additional transaction costs, decapitalize quickly, are not viable because they are not required to cover their costs and losses, and are disliked by banks. He concluded that "they do more harm than good" (9; p. 305).

Reporting default rates of 40 - 60 % of the guaranteed loans portfolio in West Africa, Balkenhol (1; p. 256 - 259) concludes that, "the funds have not succeeded in finding partners among the commercial banks and the SMEs (*small and medium enterprises*) have not really benefited from their intervention." In theory, Balkenhol considers European-type mutual guarantee associations (MGAs) of professional associations a viable alternative - provided there is rigid screening by the members, the fund is financed by its members' contributions, the guarantees are solid, and there is no government interference. In actual practice, however, "the attempts already made to set up and run MGAs in West Africa show that the road is a long and difficult one. The envisaged MGA attached to the Dakar Chamber of Commerce, for example, appears to have got off to a false start and to lack the qualities that characterise a mutual benefit

association: its foundation was decided from above; the members, belonging to different brances of activity, hardly know each other; the Government was expected to put up most of the capital; and finally, to date only one member has paid his contribution to the capital fund." (1; p. 252)

As most credit guarantee schemes rely on direct or indirect subsidies, their basic function may be to shift losses to a third party, i. e. the government or a donor. Insofar as these losses are a result of moral hazard, leading banks into negligent lending and customers into careless borrowing, credit guarantee schemes lose their very function. Schmidt (9; p. 328 - 9) points out that banks perform credit insurance functions as part of their normal operations: shifting risks by including a reserve for bad debts in their interest rate calculation, reducing risk by diversification, creating moral hazard and bearing the residual risk. Banks thereby convert an uncertain loss in the individual case into a certain, namely average, loss to be covered by the premium. Therefore, to shift, reduce and bear the risks involved in small enterprise lending, "the bank, and not the CGS/SGF, is the more efficient institutional mechanism."

As direct intervention into the lending process invariably interferes with operational laws of viability, one may propose to **leave banking to the banks**, in all its aspects, including risk-coverage. If subsidies cannot be avoided for political or humanitarian reasons, **subsidize institutions, not financial parameters**, e. g. by training bank staff in small enterprise lending!

2. Credit guarantee schemes in the Philippines

There is a multitude of credit guarantee schemes in the Philippines, many directly connected to government-supported loan schemes. In response to World Bank recommendations there has been a recent tendency from the supply of liquidity and interest rate subsidies to credit guarantees. The following data are largely from the World Bank's Financial Sector Study (15).

In agriculture there are four major schemes: GFSME - Guarantee Fund for Small and Medium Enterprises; QGFB - Quedan Guarantee Fund Board; PCIC - Philippine Crop Insurance Corporation; and CALF - Comprehensive Agricultural Loan Fund. **GFSME** started operations in 2/1984 to induce banks into small and medium-scale rural lending. It first comprised a liquidity and an interest rate subsidy component, but these gradually diminished in importance. **QGFB** comprises three Quedan Financing Programs where banks, traders and millers lend on the basis of *quedans* or warehouse receipts. The Quedan Financing Program for Food Traders and Processors, established in 1978, uses accredited rural banks and private commercial banks as lending channels. The Quedan Financing Program for Farmers, set up in 1985, and Quedan Financing for Sugar, set up in 1986, use quedan traders and millers as lending conduits. The QGFB guarantees the existence of the stock against which quedans are issued. The loans are short-term. The collection rate up to 1987 was 99 %. This

testifies to the advantages of interlinked arrangements, which are usually typical of informal markets. **PCIC** was set up in 1978 to provide insurance protection and guarantee against crop losses, guaranteeing up to 80 % of the principal amount of production loans. Half of the premium for farmers is covered by government subsidies. The World Bank (15; p. 125) estimates that about 25 % of all rice and corn farmers are covered by PCIC. In 1986 **CALF** was created out of 22 separate funds by the Department of Agriculture as a guarantee fund to promote agricultural lending by financial intermediaries.

Government-directed programs for **industry**, including the micro, small, medium and large-scale sectors, are more numerous and substantially smaller than those for agriculture. **IGLF**, the Industrial Guarantee and Loan Fund, owned by the National Economic Development Authority (NEDA), was established in 1952 by CBP (Central Bank of the Philippines) to provide both liquidity and guarantees for loans to the micro, small and medium enterprise sector. Participating commercial banks, rural and thrift banks, private development banks and nonbank financial institutions were reimbursed 100 % for their term lending. When the guarantee mechanism, which was at first manadatory, became optional it quickly outlived its usefulness because of increases in bank transaction costs: the guarantee fee of 2 % cannot be passed on to sub-borrowers; and IGLF claims require prior foreclose on all collateral. With a past due ratio of 4.5 %, IGLF is one of the top performers - but practically without credit guarantees. **CIGLF**, the Cottage Industry Guarantee Loan Fund established in 1980, also combined liquidity with credit guarantees. Aiming at cottage industries with collateral deficiencies, it was owned by the Department of Trade and Industry (DTI) and the National Cottage Industries Development Administration and administered by CBP. Loans were rediscountable by CBP, and up to 85 % were eligible for guarantee coverage at a fee of 2 % p. a. Out of a total fund size of P 800 million, only P 140 million were utilized for loans while the guarantee coverage was only P 25 million. Poor collection performance led to its suspension in 1985.

PhilGuarantee was created in 1974 to provide guarantee coverage to Filipino exporters on their local and foreign borrowings and for bid and performance bonds. Because of its tremendous financial problems (95 % of the guaranteed loans were nonperforming) mainly caused by a small number of large construction firms, guarantees on foreign loans were discontinued and local currency guarantees restricted to small and medium-scale exporters (15; p. 130). Still, the scheme failed to substantially increase the volume of export finance.

The **Cottage Enterprise Finance Project (CEFP)** is a credit facility from the World Bank and KfW to participating financial institutions, for the financing of working capital and investment requirements of small and microenterprises. It combines subloan financing with a credit guarantee system and technical assistance. The credit guarantee system is set up by Mutual Guarantee Associations (MGAs) in the form of a guarantee fund, which is comprised of two components: a Reserved Liquid Fund (RLF) established by the MGA subscriber-borrowers through initial contributions and the

Matching Loan Fund (MLF) provided by the Development Bank of the Philippines (DBP) in form of an interest free loan. Up to 80 % of the outstanding and past-due principal loan obligation including any unpaid interest are guaranteed by the guarantee fund. Appr. 60 MGAs with about 4500 member enterprises are expected to be established throughout the Philippines. Banks are officially allowed a margin of 5 %, which is not sufficient to cover their overhead costs; there is hence little chance of success.

The *Cebu Chamber of Commerce and Industry (CCI)* was endowed with a credit guarantee fund of P 1.5 million but failed to find a bank willing to handle it. CCI therefore decided to use the fund for direct loans to members. But its venture into banking did not fare well: its three borrowers failed to repay.

3. Assessment and conclusion

The overall track record of credit guarantee funds in Third World countries is poor. In a review of credit guarantee schemes in five countries, the World Bank found that,

"In the Philippines, commercial banks continued to insist on collateral, thus thwarting the main aim of the guarantee scheme to enable entrepreneurs with good projects but inadequate collateral to have access to loans. In all (five) countries, there was a reluctance of the banks to get involved with all the bureaucratic problems which they thought the guarantee would entail." (Review of World Bank Lending to Small Enterprises, World Bank 1985, quoted in: 5, p. ix)

Despite these negative findings, the World Bank in its 1988 Philippines Financial Sector Study (15; p. 138) recommends government credit guarantee schemes praising them as a viable alternative to unviable subsidized credit programs:

"The Study endorses the recent emphasis on loan guarantee mechanisms and recommends that as many government-directed credit programs as possible should be wound down, and as quickly as possible, to be replaced by risk-reducing guarantee schemes designed to enhance borrowers' bankability. The selection of GFSME as the guarantee institution for agriculture and of IGLF for the industrial sector is sound as it enables the financial system to benefit from the specialized expertise of each institution."

This is all the more surprising as the World Bank (15; p. 134 - 5), in an evaluation of government-directed credit programs in the same study, attributes high rates of loan default, among others, to "lax loan appraisal and collection by PFIs because of loan guarantee schemes." This basic inconsistency seems characteristic of the practices of many donors. As in the field of subsidized credit which is condemned by donors in theory and supported in practice, governmental credit guarantee schemes are found ineffective and even detrimental and are nevertheless recommended and supported

at the same time. When the advantages of self-managed and self-financed credit guarantee schemes are recognized, they are at the same time undermined by direct financial contributions on a lost-fee basis. Such contradictions and inconsistencies make it difficult to avoid Schmidt's conclusion that credit guarantee schemes do "more harm than good". (9; p. 305).

However, there is one exception to the rule: the ubiquitous joint and several liability groups at the grassroots level, which operate along self-help and self-reliance principles: raising their own funds, extending credit to members, and bearing the credit risk (14). In a similar vein, Balkenhol (1; p. 252), referring to indigenous self-help organizations such as savings clubs, neighborhood groups and informal associations of artisans, recommends "reconciling the formal requirements of banks with the more informal conditions under which MGAs operate effectively . . . (and) to show greater tolerance toward informal financial practices."

This is partially in line with the World Bank's (15; p. 138) recommendation to include informal financial institutions and NGOs/SHOs in credit guarantee arrangements. However, a self-sustained scheme is not in the self-interest of international development banks, which, being banks, must lend, and therefore insist on government intervention:

"To further extend the use of guarantees in agriculture, the Government should explore the possibility of using informal rural lenders and farmers' organizations as guarantors, providing them with a guarantee fee for guaranteeing the loans of small farmers."

Such inputs of *"Easy Money"* will disrupt cooperative principles of self-reliance embedded in indigenous practices of mutual help - another example of *"How to Undermine Financial Systems and Development"* (cf. 12).

With viability and sustainability in mind, only two alternatives can be recommended, leaving risk management either (i) to the banks; or (ii) to small and microentrepreneurs through their own solidarity groups. There is mounting evidence (e. g., with GTZ support, in Indonesia, Philippines, India, Burkina Faso, Nigeria, Zimbabwe; with IFAD/UNDP support to P4K in Indonesia) that, by linking banks and solidarity groups on commercial terms and with professionalism, the best of both worlds can be combined (13; 14). It is the government's task and prerogative to provide a liberal policy environment in which banks, nonformal financial institutions such as SHGs, and linkages between them can freely operate.

Summary

Access to credit is a crucial problem for small and microentrepreneurs which governments and donors have tried to overcome with generous credit guarantees. The Philippine case shows that guarantee schemes form part of social banking and are

institutionally unviable. In actual fact they restrict, rather than encourage, lending and offer no solution to the problem of small and microenterprise finance. As they do more harm than good, only two options can be recommended: to leave risk management either to banks or to small and microentrepreneurs and their own grassroots solidarity arrangements. By linking the two on commercial terms, as promoted e. g. by GTZ in various Asian and African countries, the best of both worlds can be combined.

Zusammenfassung: Schaden und Nutzen von Kreditgarantien in der Kleinunternehmensfinanzierung - Fallstudie Philippinen

Zugang zu Krediten stellt für Kleinunternehmer ein Kernproblem dar, für dessen Lösung Regierungen und Geber Kreditgarantien anbieten. Die Philippinen als Fallbeispiel zeigen, daß Kreditgarantien ein karitatives Finanzgeschäft darstellen und institutionell nicht tragfähig sind. Sie bieten keine Lösung für das Problem der Kleinunternehmensfinanzierung und wirken sich im Endergebnis eher restriktiv als expansiv aus. Da sie mehr schaden als nutzen, stellen sich nur zwei Alternativen: das Risikomanagement entweder den Banken oder den Kleinunternehmern mit ihren Solidarhaftungsgruppen zu überlassen. Eine Optimierung des Risikomanagements wird durch Geschäftsbeziehungen zwischen Banken und Selbsthilfegruppen ermöglicht, wie sie von der GTZ in asiatischen und afrikanischen Ländern gefördert werden.

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