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Loan Guarantee Programs for Small-Scale Borrowers: *Are They Working?*[*]

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Arguments for a Loan Guarantee

In an attempt to provide small-scale borrowers like small farmers and fisherfolk, rural enterprises and others, with access to formal credit, the government has made use of loan guarantee schemes. The government believes that loan guarantee programs can address several barriers to loan access by small-scale borrowers. Said barriers include:

- the high transaction cost of small loans;
- perception of high risk of lending to small-scale borrowers; and
- lack of traditional collateral demanded by banks.

Thus, two government corporations, namely, the Quedan Rural Credit and Guarantee Corporation and the Small Business Guarantee and Finance Corporation, and one program, the Guarantee Fund for Small and Medium Enterprises under the Livelihood Corporation, a government corporation under the Office of the President, provide loan guarantee to small-scale borrowers.[1]

What are the basic assumptions that warrant the use of loan guarantee schemes? One, financial markets are imperfect and exclude certain clientele, e.g., small-scale borrowers, from the borrowing process. Two, banks are unwilling to provide loans to these excluded clientele because of perceived loan-recovery risks resulting from lack of acceptable loan collateral. Three, loan guarantees provide banks with a loan security that effectively reduces loan-recovery risks. Loan guarantees, therefore, provide an insurance against loan defaults by "risky" borrowers. The guarantee's essence is the transfer to a

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[*]a.k.a. "The Tale of the Elephant that Gave Birth to a Mouse." This draws on several studies on loan guarantee programs in the Philippines (Orbeta, Lopez and Adams 1998; Llanto and Magno 1993; and Llanto, Casuga and Magno 1991). The Orbeta study was undertaken under the auspices of the National Credit Council. Llanto and others' studies were sponsored by the Agricultural Credit Policy Council.

[1]The Department of Agriculture's Comprehensive Agricultural Loan Fund (CALF) also used the Philippine Crop and Insurance Corporation to provide loan guarantees to rice and corn farmers.

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third party, the loan guarantee agency, or the government in case of a sovereign loan guarantee, a portion of the loan recovery risks associated with lending to small-scale borrowers.

The question now is: are the loan guarantee schemes working?

In this regard, this *Policy Notes* issue revisits previous studies assessing the performance of these programs. Based on these studies' finding that said schemes failed to address the problem of providing small-scale borrowers with access to formal credit, this *Notes* recommends that an immediate review of this type of government intervention in the credit markets be made.

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Previous Assessment of Loan Guarantee Programs

Two local (Llanto and Magno 1993; and Llanto, Casuga and Magno 1991) and two foreign (Gudger 1994; Seibel 1995) studies had previously assessed the performance of the three loan guarantee programs earlier mentioned. All reported a generally negative result, namely, that the loan guarantee scheme has failed to motivate bank lending to small-scale borrowers.

In the 1991 study, the following were the overall findings:

- The total number of loans given on the strength of a loan guarantee was small;
- Other forms of collateral secured many of the loans covered by the loan guarantee;
- Private bank participation in the loan guarantee programs was low;
- Guarantee fees paid covered only a small fraction of the cost of operating these programs; and
- Time-consuming procedures in the programs contributed to a high transaction cost of borrowing.

The 1993 study, meanwhile, concluded that:

- There is little difference in the characteristics and transaction costs between borrowers with loan guarantees and those without; and
- Loan guarantees failed to substitute for traditional forms of collateral.

The conclusions in the Gudger (1994) and Seibel (1995) studies are very similar to the findings of local researchers, with Seibel making extensive use of local researchers' previous data and information on the loan guarantee programs.

Attempts to Improve the Programs

There have been attempts, of course, on the part of loan guarantee institutions to reform their respective programs based on the assessment done by local researchers. For example, changes in procedures have somehow addressed certain features of the programs. As a result of improvements in the programs, the institutions claim that many of the guaranteed loans went to borrowers who would otherwise not have been able to obtain bank loans. For instance, the large guaranteed loans made to marketing intermediaries indirectly benefited numerous poor people who obtained subsequent informal loans from the intermediaries.

Most Recent Study

Recently, Orbeta, Lopez and Adams (1998) did another study on the programs' performance. The study used two complementary frameworks, namely, the overall benefit-cost framework and a framework looking at the outreach and the sustainability of the programs. The benefit-cost framework compared the social and private benefits of the programs with their costs. The second framework compared the outreach with the costs of the programs. Outreach refers to the number of new borrowers who received loans because of the loan guarantee. Sustainability refers to whether the programs can continue to exist without additional subsidies from taxpayers.

To assess the performance of the three loan guarantee programs, Orbeta, Lopez and Adams made use of various reports on the loan guarantees, financial statements and files of the guarantee agencies and participating lenders, and interviews of participants in loan guarantee programs in and around Manila, Batangas, Cebu City, General Santos City and Nueva Ecija.

The study's findings are:

- The loan guarantee programs failed to stimulate bank lending to excluded (target) groups. Their outreach has been disappointingly limited. The number of loans being guaranteed is small and the additional number of loans that were stimulated by the guarantee schemes is an even smaller number;
- These programs are heavily subsidy-dependent and their implementation will mean continuing substantial subsidies since their operating expenses far exceeded guarantee fee receipts; and
- Most policy options that might increase program outreach will further worsen the problems of sustainability and subsidy-dependency. Escalating guarantee claims, excessive operating expenses, and inflation are rapidly eroding the real values of the guarantee funds. Without hefty periodic infusions of government funds, these programs run the risk of collapsing.

"...Programs are heavily subsidy-dependent and their implementation will mean continuing substantial subsidies since their operating expenses far exceeded guarantee fee receipts."

Recommendation

An audit should be done as soon as possible on the three loan guarantee institutions. Audits should include actuaries who will document the extent to which future guarantee claims and loan losses are accurately booked. Auditors should also provide estimates of the life of each of these programs without further subsidies.

Based on the results of these audits, policymakers could then make decisions about the future of these schemes. That decision might involve liquidating the guarantee programs and using the remaining funds for other efforts that have a more positive impact on poverty reduction.

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