

## Are Public Credit Guarantees Worth the Hype?

Facundo Abraham

Sergio L. Schmukler

*Public credit guarantees have become a popular instrument to try to expand lending to financially constrained firms. In many instances, these schemes have proven useful to increase access to finance. However, public interventions to extend guarantees need to be designed, evaluated, and monitored properly. Otherwise, they could prove unnecessary or bring about important costs, such as increased moral hazard or implicit subsidies.*

Credit guarantee schemes have existed for a very long time, with the oldest schemes dating back to the nineteenth century. However, it was not until the 1990s that these instruments gained notoriety and expanded worldwide. Since then, brand new schemes have appeared in many countries and existing schemes have been reformed, expanding their scale and outreach. By 2015, they were present in virtually every country in the world (Pombo, Molina, and Ramírez Sobrino 2015).

The public sector has been a key force behind the propagation of credit guarantee schemes. Governments started to increase the use of guarantees as a way of channeling credit toward specific sectors, geographical regions, and firms (typically, small and medium enterprises, or SMEs) that tend to be financially constrained. Furthermore, public schemes have greatly expanded since the 2007–08 global financial crisis as a means to boost private lending countercyclically.

This policy brief attempts to answer two important questions regarding credit guarantees. First, is there a need for state intervention for these guarantees to emerge and persist over time? Second, to what extent have public credit guarantees had a positive impact in terms of expanding finance to financially constrained firms and enhancing performance of those firms that have received guaranteed lending?

### How Do Public Credit Guarantees Work?

When a loan is guaranteed, a third party, known as the guarantor, promises to pay back to the creditor a part or the total amount of the loan if the borrower defaults. In exchange for providing the guarantee, the guarantor collects a fee from the creditor. Because the creditor faces lower risk when a loan is guaranteed, it can offer better lending conditions and require lower collateral to guaranteed borrowers. Banks using guarantees can reduce their loan loss provisions, which increases profits and capital levels.

Credit guarantee schemes can emerge for different reasons (Honohan 2010). Guarantors can have an informational advantage over lenders. For example, credit guarantee schemes established by small business associations can screen member firms better than financial institutions. Moreover, guarantors might be able to diversify risks better than financial institutions. Whereas financial institutions can be geographically concentrated or focused on specific types of borrowers, guarantors can spread risk by guaranteeing loans in different financial institutions with different lending profiles. In some cases, these schemes can also develop in response to regulatory arbitrage. For example, guarantees can make otherwise insufficiently unsecured loans comply with regulatory requirements.

Although these arguments imply that credit guarantee schemes would be able to emerge and develop privately with no state intervention, in many cases governments participate in these schemes, often directly. Public credit guarantee schemes typically take two forms. On the one hand, the state can set up and manage its own guarantee scheme. On the other hand, the government can partner with the private sector and establish a public-private guarantee scheme. In this case, the state can retain either a majority or a minority stake in the scheme.

In response to the state's involvement in credit guarantee schemes, the World Bank has issued a set of principles for the design of public guarantees that are efficient and financially sustainable (World Bank 2015). For example, management needs to be independent from political interference and be selected according to clearly defined criteria. Furthermore, private participation is encouraged to promote governance and responsibility. Coverage ratios (representing the fraction of the loan value that is guaranteed) need to leave enough risk to the lenders to motivate them to properly assess and monitor borrowers. In addition, establishing costless and speedy claim procedures can increase credibility and encourage lenders to participate. Transparency and oversight are also key features

*Affiliation: Development Research Group, the World Bank. E-mail addresses: [fabraham@worldbank.org](mailto:fabraham@worldbank.org), [sschmukler@worldbank.org](mailto:sschmukler@worldbank.org).*

*Objective and disclaimer: Research & Policy Briefs synthesize existing research and data to shed light on a useful and interesting question for policy debate. Research & Policy Briefs carry the names of the authors and should be cited accordingly. The findings, interpretations, and conclusions are entirely those of the authors. They do not necessarily represent the views of the World Bank Group, its Executive Directors, or the governments they represent.*

*Acknowledgement: We received very useful guidance and comments from José De Luna Martínez and Norman Loayza.*

**Table 1. Characteristics of Public Credit Guarantee Schemes**

Regions	Age	Employees	Outstanding guarantees (% of GDP)	SMEs served	Outreach (%)	Default rate (%)
Global median	21	99	0.11	1,383	1.6	2.5
Africa	26	26	0.01	77	0.3	17.1
Asia	27	371	0.10	17,293	2.7	1.2
Europe	22	93	0.29	1,139	0.9	2.9
Middle East and North Africa	12	40	0.12	829	2.2	3.8
Western Hemisphere	19	64	0.05	6,531	3.4	2.0

Source: Calice 2016.

Note: All values are median values for 2014. Outreach is defined as the percentage of served SMEs to total SMEs in the country. The default rate is defined as the percentage of nonperforming guarantees to total outstanding guarantees. Data include 60 public credit guarantees in 54 countries. SMEs = small and medium enterprises. Western Hemisphere includes North America, and Latin American and the Caribbean.

of a successful public scheme. With respect to pricing, the level of the fees would depend on the scheme’s purpose. If the goal of the scheme is to address a market failure such as asymmetric information, it might have to temporarily offer subsidized fees to attract lenders while borrowers learn about them. If the scheme is not addressing a market failure, higher fees would be justified. But in the latter case, the question would be why private sector participants are not providing the guarantees themselves.

### Public Credit Guarantees Around the World

More than 30 percent of credit guarantee schemes around the world have some form of state ownership, according to a survey by Beck, Klapper, and Mendoza (2010). Public credit guarantee schemes are particularly important in developing countries, where they are the main type of guarantee scheme. In contrast, in developed countries private schemes tend to prevail.

#### Box 1. Types of Public Credit Guarantee Schemes.

Countries across the world have adopted different models of public credit guarantees. In many countries, a single state agency provides the guarantees (examples include Chile, Estonia, Indonesia, the Republic of Korea, Thailand, and the United States).

In other cases, public schemes can operate in a more decentralized manner. For example, in Japan, there are 51 state-run credit guarantee corporations under the umbrella of the Japan Federation of Credit Guarantee Corporations (JFG).

In some countries, the state is not directly involved in granting guarantees. In the United Kingdom, the British Business Bank (BBB), a state-owned development bank,

Public credit guarantees are relatively new, having been in place for around 20 years in general. The median scheme around the world has outstanding guarantees equivalent to 0.11 percent of GDP and fewer than 100 employees. In addition, it serves less than 2 percent of total SMEs in a country. However, the size, outreach, and performance of these schemes widely vary across regions (figure 1).

In general, when the public sector manages the guarantee schemes, the private sector does not participate (Calice 2016). The types of guarantee schemes led by the state differ across countries. In some countries, public schemes are administered in a centralized manner, whereas in others, these schemes consist of local and regional funds overseen by a central institution. In some cases, the public sector can be directly involved in granting guarantees, whereas in other cases the state provides strategic direction but has little control on how the scheme is run (see box 1 for

sets the eligibility criteria for firms applying for a guarantee and provides the funding. However, the BBB does not decide on guarantees applications, which is done directly by financial institutions.

Other countries have opted for public-private guarantee schemes with different degrees of government participation. For instance, in France, credit guarantees are offered through an organization owned 90 percent by the state and 10 percent by banking groups. In Spain, guarantees are provided by private schemes. The state intervenes through the Compañía Española de Reafianzamiento (CERSA), which is a public institution that grants counter-guarantees to private schemes, provides tax reductions for their operations, and sets the coverage ratios of guarantees.

examples of different designs of public credit guarantee schemes around the world). Furthermore, public schemes differ in terms of their coverage ratio, pricing, eligibility criteria, and debt recovery arrangements, among other features.

### The Impact of Public Credit Guarantees

The performance of public credit guarantee schemes can be measured by whether they generate “financial additionality” and “economic additionality.” Financial additionality refers to whether these schemes increase credit and enhance lending conditions to targeted firms. Economic additionality refers to whether firms that receive guaranteed loans improve their performance (in terms of growth, investment, employment, among other indicators).

The literature has found some evidence of financial additionality. For example, 67 percent of loans guaranteed by the Canada Small Business Financing Program have been granted to SMEs that otherwise would not have obtained credit (Seens and Song 2015). Similarly, public credit guarantee schemes have increased lending to SMEs in Italy (de Blasio et al. 2014) and Japan (Uesugi, Sakai, and Yamashiro 2010). Evidence of financial additionality has also been found in developing countries. The National Guarantees Fund in Colombia has been successful in increasing loans to SMEs (Castillo Bonilla and Girón 2014). Likewise, Chile’s State-Owned Guarantee Fund for Small Entrepreneurs (FOGAPE) has expanded the volume of lending to microenterprises and small firms (Cowan, Drexler, and Yañez 2015).

However, public credit guarantee schemes can also have negative effects. As in Italy and Japan, the credit-worthiness of firms that participated in the Malaysian scheme declined and their default rates increased (Boocock and Shariff 2005). In Germany (as well as in other countries, like the Netherlands), these schemes have been associated with higher risk-taking by banks, an indicator of increased moral hazard (Gropp, Gruendl, and Guettler 2014). Furthermore, there is evidence that in some countries guaranteed loans were extended to financially unconstrained firms, generating deadweight losses by providing scarce financing to firms that did not need it, resulting in a loss to the economy (Zia 2008, among others).

Evidence on economic additionality is also mixed. Guaranteed loans have been found to increase employment in the United States (Craig, Jackson, and Thompson 2008) and Central and Eastern Europe (Asdrubali and Signore 2015). In the Republic of Korea, firms participating in public credit guarantee schemes

increased their sales and survival rates (Oh et al. 2009). Similarly, the French loan guarantee program led to higher growth of participating firms relative to nonparticipating ones (Lelarge, Sraer, and Thesmar 2010). In contrast, credit guarantees do not seem to have increased the performance of firms in Italy (D’Ignazio and Menon 2013). Furthermore, there is evidence that in Japan the performance of firms that received guaranteed loans not only did not increase but even deteriorated.

In addition, some public schemes are not financially sustainable, requiring constant capital injections from the government, potentially creating a fiscal burden for the public sector and losses for taxpayers. For example, this could occur because the schemes are being used to pursue political goals (such as to create employment or prevent unprofitable businesses from failing). In some cases, these schemes are also being used to cover the loan portfolio of state-owned banks.

### Policy Discussion

Policy makers across the globe have resorted to public credit guarantee schemes to try to alleviate financing constraints. However, it is not clear from either a theoretical or an empirical standpoint that state intervention in these schemes is always required.

Supporters of public schemes argue that they are helpful to reduce problems of information asymmetries. However, this argument implies that the state has an informational or enforcement advantage over private agents, which might not necessarily be the case. A second argument in favor of public schemes is that they can be used to subsidize the initial costs of learning about new groups of borrowers. But this argument would only support a temporary use of public schemes: once financial institutions acquire the necessary knowledge, these schemes would need to be ended. A third argument is that the state can spread risks more broadly than markets because of its ability to deal better with collective action frictions (situations in which no individual agent has incentives to act to solve a problem, even though that would benefit everyone). Thus, public guarantees could promote lending in the presence of high risk or high aversion to risk.

Even if the arguments in favor of guarantees are valid, the positive effects need to offset the increased moral hazard (the pervasive incentives for banks to lend to riskier borrowers) that accompanies publicly led schemes. Because risk is partially transferred to the government, banks might have less incentive to screen and monitor borrowers. Furthermore, it is not straightforward that public schemes are better than other

available tools to encourage lending to new markets (such as direct lending requirements for financial institutions). The answer to this question requires conducting a cost-benefit analysis of public credit guarantee schemes and comparing them with alternative state interventions.

The empirical evidence has not been helpful in settling this debate. In some cases, the use of public schemes has been beneficial, whereas in other cases, they have imposed costs with their net effect being unclear. The varying degree of success of public schemes depends in part on whether they are effectively addressing a market failure. Differences in the design of public schemes could also explain heterogeneities across countries.

Further work is needed to accurately evaluate the impact and long-term sustainability of public credit guarantee schemes. This work could focus on the critical factors that can promote sound performance of credit guarantee schemes (such as governance, pricing, and risk management practices). Additional work could also try to understand why private schemes might not develop on their own and the role of different factors in their development, such as the need for reliable data on SMEs, the cost to collect debt after defaults, the existence of secondary markets for nonperforming loans, and the importance of a sound

legal framework. Other work could investigate when public schemes are warranted.

Future analyses should try to overcome the existing methodological challenges in measuring the impact of public credit guarantee schemes (Gozzi and Schmukler 2015; Ioannidou et al. forthcoming). Comparing firms that receive guarantees with firms that do not might be difficult because they could be systematically different, or other reasons might be affecting firms' performance. Even when firms with and without guarantees are otherwise comparable, comprehensive data on a large and representative sample of both groups of firms might not be available. Timing is also important because guarantee programs are usually put in place in the presence of negative shocks. Thus, comparing the effects of this policy with a counterfactual scenario that does not involve a downturn might lead to biased results. An extra difficulty is accurately measuring whether credit guarantee schemes are leading to additional lending or, instead, creditors are switching from unguaranteed to guaranteed credit, so that on net there is no additional lending. Another obstacle is determining how much time is needed before results can be observed. Lastly, even when firms receiving credit guarantees obtain more credit and grow faster, they could be displacing other firms, with no aggregate effect on growth.

## References

- Asdrubali, P., and S. Signore. 2015. "The Economic Impact of EU Guarantees on Credit to SMEs: Evidence from CESEE Countries." European Economy Discussion Paper 2, European Commission.
- Beck, T., L. Klapper, and J. C. Mendoza. 2010. "The Typology of Partial Credit Guarantee Funds around the World." *Journal of Financial Stability* 6 (1): 10–25.
- Boocock, G., and M. N. M. Shariff. 2005. "Measuring the Effectiveness of Credit Guarantee Schemes: Evidence from Malaysia." *International Small Business Journal* 23 (4): 427–54.
- Calice, P. 2016. "Assessing Implementation of the Principles for Public Credit Guarantees for SMEs: A Global Survey." Policy Research Working Paper 7753, World Bank, Washington, DC.
- Castillo Bonilla, J. A., and L. E. Girón. 2014. "Cuantificación de la Importancia del Fondo Nacional de Garantías en la Movilización de Créditos a las Pymes." *Estudios Gerenciales* 30: 18–24.
- Cowan, K., A. Drexler, and A. Yañez. 2015. "The Effect of Credit Guarantees on Credit Availability and Delinquency Rates." *Journal of Banking and Finance* 59 (C): 98–110.
- Craig, B. R., W. E. Jackson, and J. B. Thompson. 2008. "On Government Intervention in the Small-Firm Credit Market and Its Effect on Economic Performance." In *Entrepreneurship in Emerging Domestic Markets*, edited by G. Yago, J. R. Barth, and B. Zeidman. Springer.
- de Blasio, G., S. De Mitri, A. D'Ignazio, P. Finaldi Russo, and L. Stoppani. 2014. "Public Guarantees to SME Borrowing. An RDD Evaluation." Dipartimento di Scienze Economiche e Aziendali Marco Fanno, Università degli Studi di Padova.
- D'Ignazio, A., and C. Menon. 2013. "The Causal Effect of Credit Guarantees for SMEs: Evidence from Italy." Working Paper No. 900, Bank of Italy.
- Gozzi, J. C., and S. L. Schmukler. 2015. "Public Credit Guarantees and Access to Finance." *European Economy: Banks, Regulation, and the Real Sector* 2: 101–17.
- Gropp, R., C. Gruendl, and A. Guettler. 2014. "The Impact of Public Guarantees on Bank Risk-Taking: Evidence from a Natural Experiment." *Review of Finance* 18 (2): 457–88.
- Honohan, P. 2010. "Partial Credit Guarantees: Principles and Practice." *Journal of Financial Stability* 6 (1): 1–9.
- Ioannidou, V., J. Liberti, T. Mosk, and J. Sturgess. Forthcoming. "Intended and Unintended Consequences of Government Credit Guarantee Programmes." In *Finance and Investment: The European Case*, edited by C. Mayer, S. Micossi, M. Onado, M. Pagano, and A. Polo. CEPR and Oxford University Press.
- Lelarge, C., D. Sraer, and D. Thesmar. 2010. "Entrepreneurship and Credit Constraints: Evidence from a French Loan Guarantee Program." In *International Differences in Entrepreneurship*, edited by J. Lerner. University of Chicago Press.
- Oh, I., J.-D. Lee, A. Heshmati, and G.-G. Choi. 2009. "Evaluation of Credit Guarantee Policy Using Propensity Score Matching." *Small Business Economics* 33 (3): 335–51.
- Pombo, P., H. Molina, and J. N. Ramírez Sobrino. 2015. *The Guarantee Systems: Keys for the Implementation*. Spanish Association of Accounting and Business Administration.
- Seens, D., and M. Song. 2015. "Requantifying the Rate of Incrementality for the Canada Small Business Financing Program." SME Research, Industry Canada.
- Uesugi, I., K. Sakai, and G. M. Yamashiro. 2010. "The Effectiveness of the Public Credit Guarantees in the Japanese Loan Market." *Journal of the Japanese and International Economies* 24 (4): 457–80.
- World Bank. 2015. *Principles for Public Credit Guarantee Schemes for SMEs*. Washington, DC: World Bank.
- Zia, B. H. 2008. "Export Incentives, Financial Constraints, and the (Mis)Allocation of Credit: Micro-Level Evidence from Subsidized Export Loans." *Journal of Financial Economics* 87 (2): 498–527.