CHAPTER II

SELECTIVE REVIEW OF THE LITERATURE

2.1 Credit Guarantee Schemes In Other Countries In The World

The economic activities of the poor are too important a force to be ignored. In rural areas, in addition to the legion of subsistence and small farmers, there is a growing percentage of individuals whose primary source of income is trading, cottage industries and a wide range of services, generally categorized as off-farm activities : the figure ranges from 19 to 23 percent in countries like India, Sierra Leone and Colombia, from 28 to 38 percent in Indonesia, Pakistan, Kenya and the Phillipines and as high as 49 percent in Malaysia[1]. In many countries, those who engage in these activities are the landless, who are arguably the poorest group in the society.

In urban areas, "microenterprises[2]" often represent half or more of the labor force in the sprawling cities of the developing world. In Lagos, half the employment is in the informal sector[3]. In Bombay, the figure is 55 %[4]. The informal sector in Latin America and the Caribbean, the majority of which is in the cities, makes up a third of the economically active popula-

1. Kéddie, Nanjundan & Teszler (1988), Table II.1.

2. These are the smallest of small enterprises.

3. Sethuraman 1981, p.214.

4. Mazumdar 1976, p. 655-79.

tion, or some 30 million people.[1]

These businesses have a crucial role to play in developing economies. Subsistence and small farmers and rural and urban microentrepreneurs :

* will generate a majority of the 120,000 jobs a day needed in the developing world between now and the year 2000;
* will represent an even larger percentage of the jobs needed for women, recent immigrants from rural areas, the uneducated, youth and the poorest;
* provide goods and services, for example , food, inexpensive shoes and farming tools, often in small quantities, to the poor;
* provide much of the skills and entrepreneurial training in developing countries;
* represent the best mix of capital, labor and energy in a poor society; and
* provide a vital link to modern enterprises, distributing their products and producing finished goods for resale and export.

The 1988 World Conference on Microenterprises referred to the informal sector as " the major development agent for employment creation, income generation and social stabilization in the next decade. "[2] This sector of the economy is growing in importance in most countries, but it faces obstacles that affect

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1. Inter-American Development Bank, 1988.
2. UNCDF , 1988.

the growth, profitability and even the sustainability of these smallest economic initiatives, namely :

* an almost total lack of access to institutional credit from banks and other lending instituions who feel lending to the poor is too risky and expensive;

* a dependence on moneylenders and suppliers who charge rates ranging from 20 percent a month to 20 percent a day[1] in many countries;[2] and

* a hostile policy environment that provides good access to credit and other services to larger business and farms while making access to credit for the smallest scale enterprises difficult if not impossible[3]

Hence, credit guarantee schemes can play a very important role in encouraging financial institutions to provide "guaranteed" credit to this "informal sector."

Levitsky and Prasad (1991) argue that credit guarantee schemes can be an effective means of supporting small enterprise development, especially in countries where access to credit is constrained for small borrowers. Their survey of credit guarantee

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1. Ashe, 1981 , p.xii.

2. Lack of working capital often leaves the business owner little recourse other than to buy from certain suppliers on credit and at a very high prices, thus exacerbating the common problem of chronic indebtedness.

3. Typical problems in urban areas are policies banning street vendors from choice downtown locations, and licensing and registration requirements that are extremely time-consuming, complex and expensive from the perspective of micro-business owners. Bribes must often be paid to keep clandestine businesses functioning.

in 27 developed and developing countries showed that schemes have succeeded most often when the following conditions are met :

i. Commercial banks must participate in the scheme. Participation by publicly-funded Development Finance Institutions is meaningless since their losses will be covered automatically by public funds.

ii. Each request for a guarantee should be investigated independently of the lending institution to guard against banks' transferring their riskier loans to the guarantee programme. Automatic guarantees should be avoided.

iii. The optimal loan percentage to be guaranteed appears to be between 70 and 80 percent. Where the risk for banks is more than 20 percent, the costs of appraising and securing their portion of risk do not justify the costs of obtaining a guarantee; where the risks are less than 20 percent, the least viable loans may be proposed for guarantees because banks have little to lose.

Webster (1991) wrote a review that evaluated the performance of World Bank lending to 70 SME projects in 36 countries spanning the period from Financial Year 1973, when SME lending was initiated in the Bank, through Financial Year 1989. The purpose was to analyze and evaluate institutional delivery systems supported by the Bank's SME projects.

Webster (1991) identified that those credit guarantee schemes that did not achieve their objectives failed to establish the necessary conditions for success :

i. Many of the participating banks were publicly-owned.

ii. Ten of the twenty-three projects with schemes guaranteed between 50 and 70 percent of subloan amounts, with the implication that the costs to retail banks of obtaining the guarantee may not have been worth the benefits received.

iii. Most of the guarantee schemes that failed were under-capitalized in relation to claims made. Large claims for reimbursement stemming from low repayment rates could not be covered by guarantee fees that ranged from 1 - 2 percent of amounts outstanding.

iv. Many credit organizations had difficulties establishing operating policies and procedures. Once established, many were inefficient with overly complex and slow operations.

v. As credit guarantee programmes failed to meet their objectives, distrust developed on the part of retail banks and systems essentially fell apart.

From the above, we can detect some similarities between the findings of Levitsky, et. al.(1990) and Webster (1991) in that both agreed that credit guarantee schemes should not be participated by publicly-owned financial institutions, but by the commercial banks. They also agreed that the loan percentage to be guaranteed by the credit guarantee schemes is very important and may directly affect the wilingness of banks to participate in the schemes.

Moreover, Ashe, Jeffrey, et. al. (1989) also identified

twelve[1] characteristics of successful lending projects; one of which is similar to that of Levitsky, Jacob, et. al. (1990) and Webster (1991) is that successful lending projects are managed by the local banking sector, or work in close co-ordination with the local banks. Another similar characteristic of successful lending projects identified by Ashe, Jeffrey, et. al. (1989) and Webster, (1991) is regarding the projects' or schemes' operating policies and procedures. Both agreed that overly complex policies and procedures should be discouraged as these will result in slow and inefficient operations of the lending projects or schemes.

Levitsky, Jacob, et. al. (1990) also present evidence concerning four key issues relevant to credit guarantee schemes. The first is their costs. Governments and guarantee organizations should understand clearly that guarantee fees normally are insufficient to cover the costs of administration and claims. Second, the credibility of guarantee schemes rests primarily on the transparency and simplicity of the requirements for payment of claims and the efficiency with which claims are paid. Third, guarantee schemes do not absolve banks from taking the normal risks associated with lending or from selecting only the most viable firms and obtaining personal guarantees and / or collateral. Finally, guarantee schemes have worked best where clients are creditworthy entrepreneurs with viable projects and insufficient collateral as opposed to questionable clients and / or risky projects.

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1. Ashe, Jeffrey, et. al. (1989) , p. 19 - 22.

Webster (1991)'s findings also showed that the initial SME projects exhorted participating banks to appraise projects and approve or reject them based on the merits of the project and the prospective borrower, with little reliance on collateral as security. Project officers interviewed indicated that most participating financial institutions essentially have resisted the World Bank's push to lend to clients without collateral, although some have lent on the basis of capital equipment purchased with the subloan. There are no systematic data available on the level of collateral that is being required. Participating financial institutions in both Ecuador and Sri Lanka experienced losses after making loans based solely on the merits of the project itself. They have since adjusted their criteria so that they rely on a mix of collateral, analysis of project viability, and the character of the borrower. With hindsight, this approach seems a prudent term lending practice.

The World Bank has also argued consistently that final interest rates charged to subborrowers under SME lines of credit should be positive and market-determined. The primary case for market rates is that banks must be allowed to set rates that will cover their costs and ensure profits, if they are to incorporate SME lending into their normal lending operations. A second argument says that subborrowers will repay their loans at higher rates if they pay market rates and are not given the impression that loans are part of government give-away programmes. Subsidized rates have a number of additional deleterious results,

namely : less viable and more capital-intensive projects can qualify for loans; larger and better-connected clients often are the recipients of low-cost credit; fixed interest rates cannot shift with the economy and can become negative in periods of inflation; and credit programmes have chance of attaining self-sufficiency as long as they are operating with subsidies. Many governments are unwilling to charge small borrowers market rates because it might be unacceptable politically or because they believe that SMEs should be subsidized because small entrepreneurs often are among the poor.

Of the loans reviewed by Webster (1991), 43 have employed commercial interest rates and 27 have offered subsidized rates. Among completed loans, 19 projects have had commercial or close to commercial rates and 14 projects have had subsidized interest rates. An analysis of projects with high repayment rates shows little relationship between subsidized interest rates and repayment of subloans.

2.2 Credit Guarantee Scheme In Malaysia

Several seminars organized by Credit Guarantee Corporation Malaysia Berhad and also by the Association of Banks in Malaysia have come up with some common problems and also some controversies.

The Association Of Banks in Malaysia has organized a CGC Seminar in 1979 which discussed common problems faced by commercial banks through CGC lendings. The problems were divided into two major aspects namely : practical and administration ,

and technical aspects.

The practical and administration aspects include

i. although the purpose of the loan is easy enough to establish, commercial banks encountered difficulties in establishing the integrity of the borrower and the viability of the borrower's business. The general experience of commercial banks in lending under the scheme is that many of the applicants do not keep proper accounting records of their business and hence are unable to produce audited balance sheets or profit and loss accounts on which the banker may readily rely on to assess the company's viability in relation to the application. In the absence of such information the banker would have to undertake much more research and investigation into the application before he can arrive at a practical basis on which he may assess the viability of the business.

This problem was also voiced out by Zainol Arifin Bador during a CGC Seminar held in 1985. He termed it as 'tedious and difficult appraisal'. Financing small businesses is a specialized function because there are certain distinctive and peculiar characteristics of small business which make the task of appraising and assessing them somewhat tedious and difficult as compared to corporate lendings. The Credit Appraisal Form which was introduced and must be completed for every borrower does appear to be voluminous.

ii. To ascertain the integrity of the borrower is not easy as many of the applicants are 'newcomers' to the banks; few have

maintained current accounts or saving accounts before their application for loans and the bank knows no more about them apart from the information obtained from their loan applications and interviews with them. Due to this, the bank would have to undertake a lengthy process of investigation which most banks could ill afford.

iii. The paper also stresses on the importance of efficient loan follow-up and supervision and the right attitude and approach towards the small enterpreneurs. Bador (1985) also agrees that as close monitoring is another important aspect of small business financing, it is necessary for presanction visits and post sanction visits[1] thereafter.

iv. Also, the inadequate communication given to would-be applicants covering the terms governing the scheme has resulted in many applicants having the impression that money from the loans is from the Government and that loans were fully guaranteed by the Corporation.

This problem was also brought up by Datuk Tan Seng Teck, General Manager of United Malayan Banking Corp. Bhd. who said that "many farmers presumes that the loans released to them are from the Government. Thus, the facility is viewed as a form of aid which do not require repayment at all." Tan (1979) also commented that CGC lendings at times may be termed as lendings

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1. presanction visits means visits made by loan officers to the premise of the potential borrowers before disbursing the loans; and post sanction visits means visits to the premise of the borrowers after disbursing the loans.

to strangers. In most cases, the banker is unfamiliar with the borrower. In the rural areas, particularly, postal addresses of intending borrowers oftentimes are in pseudonymous form and accountees are knownby their nick-names. Bankers at times encounter "con-men" in such dealings. In other cases, the character and integrity of such a client may have to be left to chance.

The technical aspects include taking legal action against defaulters to the extent of bankruptcy proceedings. In certain cases the cost involved in such legal action may exceed the amount claimed and as all legal costs incurred are to be met by the bank, it is placed in an awkward position whereby it has to decide whether to undertake such legal action or to write off the outstandings.

One interesting findings on unsecured loans is that one of the resolutions made by Association of Banks in Malaysia during CGC Seminar 1979 is to increase unsecured loans from RM 30,000 to RM 60,000 while during the 1990 Asian Credit Supplementation Institution Confederation (ACSIC) Conference, [see Appendix I for ACSIC members], the speaker suggested that to reduce bank collateral requirements is wrong headed. Moreover, large, lumpy, long-term loans often encourage overly rapid expansion in buildings and equipment. Singh, Allan, Hiscock and Roebuck (1980) also agreed that if CGC took security from the applicant, this would simplify the procedures. The commercial banks would have good security and the CGC would have some security from the borrower. Furthermore, CGC might be able to value the collateral more favourably than a commercial bank, which traditionally takes

a conservative approach. This would reduce the amount of work to be done by commercial banks, which prefer to make a few large loans rather than many small ones. The bank would rely on the CGC guarantee. Whilst the banks could continue to be responsible for monitoring the state of the borrower's account, CGC could take over responsibility for monitoring the state of his business.

Another resolution made in CGC Seminar 1979, is that the Chamber of Commerce and related organization should play a more active role in helping the SSEs.

Bador (1985) also presented these problems in his working paper. The only difference is that he focused more on the Special Loan Scheme (SLS) which was one of CGC's products. He questioned the definition of Small-Scale Enterprise which was defined as

"any registered business with net assets of up to RM 250,000 or in the case of limited companies, shareholders funds not exceeding RM 250,000 with bank borrowing not exceeding RM 250,000."

Bador pointed out that there was a loophole in the definition. Although the definition seems clear enough but in practice considerable difficulties have been encountered by commercial banks in ensuring that the applicants are bone fide small scale businesses. In determining the net assets of a proprietorship or partnership the net worth of the proprietor or partners must be taken into consideration. However, in most

instances, it is very difficult if not impossible to determine their net worth which are unlikely to be provided voluntarily and in good faith by the proprietor or partners. In the case of limited companies, accounts can easily be manipulated for the purpose of qualifying for this scheme. The low interest rate of the Special Loan Scheme (SLS), which was 7.5% until March 1985, made it worthwhile to do everything possible to qualify. Big companies or corporations form associates or subsidiaries which would individually apply for the SLS . And, so long as there are no common directorship, approval will be readily granted. This is also mentioned in the Asian Credit Supplementation Institution Confederation (ACSIC) working paper in 1990 where the fragmentation of large firms to take advantage of such special deals is practised in India.

Unrealistic SLS target was set by Bank Negara Malaysia at 5 % of the total loans outstanding of the commercial banks as at December 31, 1980, which was RM 20,872 million. Thus, by December 31, 1985, the commercial banks are expected to lend RM 1,043.6 million to this sector and this would mean 20,872 new borrowers (maximum of RM 50,000 per borrower). This is unrealistic especially with the downturn in the economy where bankable proposals are hard to come by. Therefore, banks have to decide whether to take on the additional risks and continue to lend to marginal cases or to slow down and face the penalty of non-compliance. Under such pressures, it is possible for caution and prudence to be thrown to the wind which should never be allowed to happen. Although small scale enterprises play an important

role in the economy, it is the quality of these enterprises that is paramount and not the number or quantity. Invariably an effective target is what we should aim for and not just an arbitary one which can breed abuse and litigations.

Another issue brought up by Levitsky, Jacob, et. al., (1989) and was also published in the Malaysian Business, June 1977 , is the provision for claims by CGC. An example. given by Hardev Kaur (1977) in " CGC : Can It Do More ? " is :

"Many have doubted the ability of the CGC to meet its claims, that is, in event of default repayment, the CGC is liable for 60 % of the total sum to the commercial banks. The ground for this lack of confidence is that the CGC has a small paid up capital. For example, assuming that outstanding loans under the scheme are at RM 350 million and that if 5 % of it are bad, this would amount to RM 17.5 million. Of these, the CGC is responsible for RM 10.5 million (60 %) . However, the CGC only has a paid up capital of RM 2.5 million. Therefore, it is not surprising that many are suspicious over the CGC's ability to fulfil its commitments."

This issue was also brought up by Letvisky, Jacob, et. al.,(1989) who wrote that :

" The Malaysian scheme seems to have been poorly planned in that inadequate provisions were made for handling

claims. Five years after the central bank guidelines for CGC guarantee loans were introduced, the CGC's capital fund (including provisions for claims) amounted to only 4.4 % of its guarantee obligations, while doubtful accounts reported by the participating banks amounted to 20 % of the outstanding guaranteed credits".

According to Levitsky, Jacob, et. al., (1989), the handling of claims by CGC has also been very poor. Up to December 31, 1981, a total of 1,342 claims amounting to RM 4.39 million had been lodged with the CGC. Of these, only 132 claims for RM277,787 had been paid out, while 760 claims for RM 2.17 million had been rejected. In 1983 a total of 254 claims amounting to RM 1.9 million were considered. Total settlements made by the corporation in 1983 amounted to RM 117,122 on a total of 94 loans, compared with RM 77,000 on 45 loans in 1982. By end 1985 a cumulative total of 1,935 claims had been processed, with an additional 127 involving an amount of RM 1.45 million still outstanding. Of the claims processed only 429 were paid out, involving a total sum of RM 1.27 million. Of the remainder, 1,186 claims were rejected (for RM6.44 million) and 320 were withdrawn by the banks. Most of the claims considered were rejected or found not eligible for compensation on the ground that they did not comply with the terms and conditions of the guarantee cover. These figures explain some of the loss of confidence of the commercial banks in the scheme.

Kambali bin Kasbani (1985) has identified some reasons

for rejection of claims. The main reasons being :

i.	No proper appraisal undertaken	80.1 %	(413 cases)
ii.	Improper utilisation of facility	21.3 %	(110 cases)
iii.	No due care exercised	41.2 %	(210 cases)
iv.	Recovery efforts unsatisfactory	37.7 %	(196 cases)
v.	Non-compliance to CGC by-laws	16.6 %	(86 cases)
vi.	Misrepresentation of facts	3.7 %	(19 cases)

Source : Kambali bin Kasbani, Appendix pp. 28 - 30

In 1982, at the request of the Malaysian government, the World Bank sent a consultant to Malaysia to review the scheme. One of his findings was that the scheme was grossly underfunded in the light of the volume of guarantees given. The consultant also recommended raising the guarantee fee to 1 % and the share capital to RM 40 million, and pointed out that these measures alone would not make the CGC solvent unless the manner of its operation was changed.

During the Asian Credit Supplementation Institution Confederation conference held in 1990, some issues brought up were :

i. experience indicates that the push to reduce or remove banks' collateral requirements - limiting collateral to the project itself - probably was wrong headed,

ii. in small firms, working capital requirements - which fluctuate - far exceed fixed capital requirements. Therefore, large, lumpy, long term loans often encourage overly rapid expan-

sion in buildings and equipment. Also, particularly with new borrowers, shorter initial maturities - with the prospect of rollovers and expanded credit lines if all goes well - are often the most prudent and effective lending practices. Credit Guarantee, often geared to fixed investment and "permanent working capital" term loans, discourage rollovers by the banks, encourage large lumpy lending transanctions and may well undermine the building of solid, on-going relationships between bankers and borrowers.

iii. in a meeting of SME donors, the resounding concensus was that small firms need access - not subsidized interest rates or other special deals. A more liberal environment would allow banks to develop niche markets. In the United States, the regional commercial banks who have performed the best have cultivated the middle market - the US version of mom and pop businesses. Hence, small enterprise lending can be an excellent business preposition for commercial banks - if they are allowed to behave as banks.

iv. standard wisdom says that credit guarantees need to cover at least 70 % of the banks' risks for them to be effective in getting the banks involved and in getting them to charge collateral requirements and lending practices. However, 70 % is too high in most settings. With 70 % or higher coverage, the risks are great and banks will not take the SME portfolio seriously. 70 % or more may be justified only as a temporary measure to get the banks accustomed to lending to a set of borrowers where the banks' perception of risk is high but the real risk is

low , for example lending to women owned enterprises.

The above review identified some common characteristics of successful credit guarantee schemes / lending projects in coutries all over the World, and if applicable, these information can be applied to our local scene. Besides, the review also discussed more on the problems and issues of credit guarantee schemes including the credit guarantee schemes in Malaysia.

However, little has been written on the evaluation of the role of the Credit Guarantee Corporation (Malaysia) Berhad in financing the small and medium-sized enterprises which is the topic I have chosen to write on.