

An Example of Measures to Tackle the Crisis: Loan Guarantee Mechanism



türkiye ekonomi politikaları araştırma vakfı

Global Crisis Working
Group

**Economic Policy
Research Foundation of
Turkey**

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The policy note “2007-08 Global Financial Crisis and Turkey: Impacts and Recommendations” published on November 9, 2008 argued that the most effective channel that will transmit the impacts of the global crisis was the loan channel. The same note also addressed an economic policy recommendation that will minimize the difficulties the corporate sector will face in the upcoming period in terms of accessing domestic finance. This note aims to detail the mentioned recommendation and establish a healthier discussion framework.

What is the Loan Guarantee Mechanism and How does it Work?

Among the TEPAV recommendations communicated to the public on November 9 was the establishment of a type of “loan guarantee mechanism” that will prevent domestic banks to withdraw or sharply limit the volume of domestic loans they will extend. To place this recommendation on a solid ground, it is aimed to explain what the loan guarantee mechanism is and how it works.

It is known that the loan market has some significant failures. For instance, the entrepreneurs that do not have any loan record have difficulties in accessing loans even if they come up with a genius idea. Similarly, small sized enterprises frequently encounter difficulties in accessing finance. Whereas, it can be argued that, if such new initiatives have access to finance, they can establish businesses that operate efficiently with the latest technology. Likewise, small sized enterprises can improve their production capacity and enjoy the advantages of scale economies if they access sufficient finance facilities.

The fundamental solution developed to overcome this market failure is that a third party is incorporated into the system between the bank to extend a loan and the borrower demanding a loan, to provide a guarantee for; i.e. to warrant for the loan. Thanks to the provision of a guarantee by a third party, the risk encountered by the bank to extend the loan will be reduced. Because, if the small sized enterprise cannot overcome the problems faced in repaying the loan amount, the guarantee mechanism will step in and the bank will collect the receivables from the guarantee fund.

Under the mechanism, the profitable projects that cannot be launched due to the difficulties in access to finance have the chance to be launched. The main principle here is that the party that extends the loan, the party that receives the loan and the party that provides guarantee for the loan share the risk. Therefore, the guarantor party does not provide guarantee for the whole loan amount. In the prevalent practice, upper bound of the guarantee is set around 80 percent and thus the three parties involved share the risk.

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This type of loan guarantee mechanisms are applied prevalently in the EU countries. Turkey also has a similar fund mechanism¹. On the other hand, it is observed that though its capital has been increased recently, the volume of the fund is still insufficient. These funds in a way constitute a critical component of the financial system.

It should be noted that loan guarantee mechanisms are not profitable organizations. The main financial objective of these organizations is ensuring their own sustainability in the long run. To put it differently, these non-profitable mechanisms target – naturally – at preserving the real value of the funds they use to provide guarantee for loans. Therefore, in exchange for the guarantee they provide, the fund can receive a certain amount of commission and collateral the value of which will not put pressure on the companies for which it facilitates the access to finance.

In some cases, the Treasury of the related country serves as a contra-guarantor. In other words, when the company fails to repay the loan extended by the bank, the loss the guarantee mechanism will face due to the provision of guarantee for that loan is met through the Treasury. Though the practice is advantageous in terms of the low level of commission received by the loan guarantee mechanisms, there created an additional burden on public budget in exchange for this advantage.

How can the scope of implementation of the Loan Guarantee Fund in Turkey be expanded?

We suggest that a mechanism that will reduce the rising risk perception of the banks and that will enable the banks to extend loans with less hesitation can be established. The resource for the mechanism is recommended to be met by the public budget. For instance, resources corresponding to 1 percent of 2009 national income can be transferred to the loan guarantee mechanism. Since the mechanism will not directly extend but will provide guarantee for loans, it can provide guarantee for loans reaching high above this resource amount.

If the mechanism works with a leverage rate of six – which is a conservative assumption – it can prove guarantee for new loans corresponding to 6 percent of the national income. To understand to what extent this figure is satisfactory, it should be noted that the ratio of the total loan volume of the banking sector to the national income is around 41 percent²

On the other hand, it is obvious that expenditure priorities of the 2009 budget must be revised to establish the mentioned guarantee fund without disturbing fiscal discipline. ‘Urgency’ can be set as the basis for the re-identification of expenditure items included in the 2009 budget. It is believed that the additional resources allocated for the municipalities in 2009 budget can be subjected to reevaluation in this respect.

Part of the losses incurred in case that a portion of loans becomes nonperforming and thus the mechanism pays the guarantee amount to the bank can be met by the commissions received in exchange for the guarantee as well as the revenues obtained by turning the collaterals into cash. The amount that cannot be met this way will certainly lead to a loss and be recorded as budget deficit.

¹ Loan Guarantee Fund was established in July 1991 and provided the first guarantee in July 1994. For detailed information, please visit www.kgf.com.tr

² This ratio is calculated by dividing the total loan value figure as provided in the 12 November 2008 dated BRSA (Banking Regulation and Supervisory Agency) Daily Banking Sector report by the national income for the last four quarters.

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Nonetheless, since the mentioned budget deficit will not reach to considerable amounts unless huge risks are taken, the deficit resulting from the practice can be compensated for (in terms of present value) by cutting down the budget expenditures in the upcoming years. If the fund mechanism is administered by professionals, the efficiency-fairness balance of the mechanism and the milieu appropriate to minimize risk of political manipulation will be established. In this context, it should be emphasized that it is of critical importance to correctly identify the principles regarding the governance of the mechanism.

Concluding Remarks

It will be wise to clarify some points with respect to the loan guarantee mechanism framework. The first point to underline is that the purpose of the fund is to eliminate the tightening in the domestic loan market. By means of the mechanism, the liquidity for both existing and new loans will be ensured and the impact of the crisis on the balance sheets of private banks will be limited.

Nonetheless, it should be kept in mind that the implementation of the mechanism will not overcome the potential resource problem that can stem from the risk of contraction in the balance sheets of banks. The solution of the resource problem depends primarily on policies strengthening the confidence in the economy and then on the provision of deposit guarantees and/or capital support, if necessary. The fund mechanism recommended hereby aims to minimize the risk perception of the banks and enable them to transform the resources they hold into loans. It is expected that the recommended fund mechanism will as well contribute indirectly to the establishment of confidence in the economy.