GOVERNMENT-BACKED LOAN GUARANTEE SCHEMES FOR SMALL AND MEDIUM-SIZED ENTERPRISES: AN EVALUATION OF THE CREDIT GUARANTEE CORPORATION IN MALAYSIA

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This paper is based on an empirical study conducted when Grahame Boocock was employed as the British Aerospace Associate Professor at University Utara (North) Malaysia

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ABSTRACT

Government-backed loan schemes have been introduced in many countries to enable small and medium-sized enterprises (SMEs) to have access to funding at a reasonable cost. This paper evaluates the schemes offered in Malaysia by the Credit Guarantee Corporation (CGC).

The introduction emphasises the importance placed on the SME sector in achieving fully-industrialised status for Malaysia, and highlights the fact that the CGC has been charged with a critical role in assisting SMEs. The paper then describes the operation of the CGC and its place within the spectrum of finance aimed at SMEs, before presenting the findings of an empirical review. Three key areas are explored: the relationship between small firms, banks and the CGC; the level of finance additionality in evidence; and the level of economic additionality generated. In each of these areas, the CGC's effectiveness in meeting the needs of SMEs, banks and the wider economy appears to have been limited.

The paper then describes a radical new Scheme introduced by the CGC and assesses whether this Scheme will enable the CGC to achieve its objectives, notably a greater degree of finance and economic additionality. Finally, the implications of the CGC's experience for other developing countries are briefly summarised.

Introduction

Small and medium-sized enterprises (SMEs) in both developed and developing countries are perceived to play a crucial role (Bannock and Binks, 1989; Chee, 1992). However, many potential benefits flowing from SMEs (Note 1) will not be fulfilled if this sector cannot compete on equal terms with larger businesses. In particular, SMEs face difficulties in obtaining external funding from private sector financial institutions, notably commercial banks. These difficulties stem from a variety of interlinked factors, including: the higher risk of failure for SMEs than larger firms, especially in the early years of operation; the asymmetry in the risk profiles of lenders and SMEs; and the relatively high costs of appraisal (and subsequent monitoring) of SME advances (Hughes and Storey, 1994).

The outcome is that the financial markets often deny funds to apparently viable SMEs. Government-backed loan schemes have been introduced in many countries, enabling smaller enterprises lacking security to obtain bank funding at a reasonable cost. The government guarantees that it will repay a percentage of the loan in the event of the borrower's default.

This paper concentrates on the facilities offered in Malaysia by the Credit Guarantee Corporation (CGC).

The economic strength of Malaysia was based historically on commodities such as rubber and palm oil. Over recent years, industrialisation has accelerated: the Government is committed to a strategy of growth led by the private sector, an extensive privatisation programme is in place, inward foreign investment is being attracted, and capital and technology-intensive industries are encouraged.

In a series of national Five Year Plans, starting in 1966, official support for SMEs has been progressively increased; in the Sixth Malaysia Plan (1991-1995), great emphasis was placed on the SME sector in achieving fully-industrialised status for the nation. The experience of newly industrialised countries in Asia; and of Japan, suggests that SMEs have the potential to play a crucial role in supporting balanced growth across a modern economy.

When the CGC was established in 1972, the financial markets were relatively underdeveloped. SMEs in Malaysia, as elsewhere, found that access to finance was a major problem (Chee, 1986a). Many small firms had to resort to non-institutional sources of finance charging exorbitant rates of interest. This situation still prevailed in the 1980s, despite the efforts of the CGC and other government bodies (Fong, 1990). Furthermore, the SME sector remained "very fragmented and characterised by a lack of product differentiation and appropriate technology" (Bank Negara, 1992). The publication of such findings, coupled with increasing recognition of the importance of a thriving SME sector, led to the restructuring and strengthening of a number of public sector financial institutions, including the CGC.

The CGC's activities have previously been appraised as part of a major World Bank study (Levitsky and Prasad, 1987) and by Malaysian academics, for example Chee (1986b, p100-107) and Phang Hooi Eng (1992, p128-134). Using secondary data, these studies have tended to describe the services offered by CGC in fairly general terms or to concentrate on one aspect of the CGC's operations, notably the default rate of guaranteed firms.

In other countries, attempts to measure the utilisation and effectiveness of government-backed loan schemes have addressed more important issues. For example, reports on the United Kingdom's Loan Guarantee Scheme (Robson Rhodes, 1984; National Economic Research Associates - NERA, 1990; and, Pieda, 1992) and studies of Small Business Administration Loans in the United States (Rhyne, 1988; and, Pletcher and Tootelion, 1989) have considered whether the respective schemes provide additional finance, or simply replace existing sources of funding.

The pilot study, on which this article is based, adapts the methodology used in the UK studies for the Malaysian context. For the first time, empirical data is presented on critical issues affecting the performance of the CGC. The findings should be helpful for the CGC, financial institutions, SMEs and policy makers in Malaysia. There are also lessons for other developing countries seeking to offer government-backed loan schemes.

The structure of this paper is as follows:

- the operation of the CGC is described, together with a brief assessment of its role within the financial spectrum
- the survey methodology is outlined
- the findings of the survey are presented, focusing on the relationship between borrowers, banks and the CGC; and, finance and economic additionality
- a radical new scheme introduced by the CGC is described; the likelihood of this Scheme enabling the CGC to achieve its objectives is explored, and the lessons of the CGC's experience for other developing countries are briefly summarised.

The operation of the credit guarantee corporation

The CGC provides guarantee cover for credit facilities extended to SMEs in three broad sectors - general business, agriculture and manufacturing. The general business sector is dominant, covering such activities as the wholesale and retail trades, small-scale construction and hawkers and petty traders.

Operating from an office in Kuala Lumpur, the CGC is approached only after a lender has declined a request for conventional funding. The guarantee is approved, provided that conventional finance would have been offered if collateral had been available. The proposition is not subject to independent review by the CGC, hence the provision of the guarantee does not reduce the costs of appraisal for the lender.

The CGC's capital is held by Bank Negara (the Central Bank) and all the commercial banks. Bank Negara issues guidelines (effectively quotas) covering the amount of CGC-linked lending to be undertaken. This is a critical factor, one which has a pervasive influence on the utilisation of the schemes (Note 2). Penalties are levied on individual banks for non-compliance with targets, a frequent occurrence; for example, although 88 percent of the overall target was satisfied over the two year period until March 1993, around half of the banks failed to comply with their individual targets.

The guidelines also incorporate an obligation to assist small firms owned by the indigenous Malay community ("Bumiputeras"). Over the CGC's life-time, such firms have accounted for 55 percent of the number and approximately 30 percent of the value of loans.

Since 1972, four main facilities have been offered by the CGC:

1) The General Guarantee Scheme (GGS): 1972-81
2) The Special Loan Scheme (SLS): 1981-88
3) The Principal Guarantee Scheme (PGS): 1989-1994
4) The New Principal Guarantee Scheme: 1994-date.

The introduction of each new scheme resulted in an increase in the number and value of loans granted. However, momentum has not been sustained.

The General Guarantee Scheme (GGS) guaranteed bank facilities up to a limit of RM200,000 for enterprises whose shareholders' funds did not exceed RM200,000 (RM: Malaysian Ringgit; approximately RM4 = £1). When the Special Loan Scheme (SLS) was introduced in 1981, the limit was raised to RM250,000 for both shareholders' funds and the size of credit facilities. For the GGS and SLS, the CGC guaranteed 60 percent of the value of approved loans. Another important feature was that, until 1987, very low (and fixed) rates of interest were charged on these loans.

In 1989, the CGC decided to phase out the semi-dormant General Guarantee Scheme and the declining Special Loan Scheme, and replace them with the Principal Guarantee Scheme (PGS).

Compared to the previous schemes, the PGS offered support to larger firms; businesses with net assets or shareholders' funds of up to RM500,000 were eligible. The limit on credit facilities was also raised to RM500,000, and higher guarantee coverage (typically 70 percent of the value of the loan) was available in respect of both clean (unsecured) and secured facilities. The availability of these higher borrowing facilities was eagerly grasped by the banks and the small business community alike.

Table 1. The CGC: number and value of approved loans, 1980-94

Year	Types of Loans							
	GCS	*GCS*	*SLS*	*SLS*	*PGS*	*PGS*	*New PGS*	*New PGS*
	No	*Value RMm*	*No*	*Value RMm*	*No*	*Value RMm*	*No*	*Value RMm*
1980	6,103	124.3						
1981	1,148	25.8	17,161	498.2				
1982	294	9.7	16,664	519.3				
1983	236	7.2	10,327	298.3				
1984	150	4.0	7,841	208.2				
1985	77	2.7	5,295	140.0				
1986	40	1.8	4,560	122.5				
1987	33	1.3	3,346	75.2				
1988	20	0.7	2,450	49.8				
1089	5	0.3	1,032	21.4	1,638	78.5		
1990					5,641	313.3		
1991					3,349	206.3		
1992					2,180	174.7		
1993					2,302	205.8		
1994 (2 months)					352	32.0		
1994 (10 months)							3,146	530.1

GGS: General Guarantee Scheme; SLS: Special Loan Scheme
PGS: Principal Guarantee Scheme (withdrawn 28 February 1994)
New PGS: New Principal Guarantee Scheme (from 1 March 1994)

Source: CGC

For PGS lending, the interest rate was initially fixed at 1.5 percent above Base Lending Rate (BLR) - previously the banks had been forced to advance funds at below BLR. The new margin more accurately reflected the risks inherent in lending to SMEs and allowed the banks to earn a reasonable return in meeting the quotas. It is significant that the supply of PGS loans slowed down sharply when an interest rate cap of 9 percent was enforced by Bank Negara over most of 1991 and the first part of 1992. The guarantee premium was set at 0.5 percent of the guaranteed portion of the facility, compared to 0.5 percent of the value of the loan under the SLS.

Other schemes operated by the CGC since 1986 include those aimed at Hawkers and Petty Traders (HPTs) and their trade associations. Since 1986, over 23,000 HPT guarantees have been approved, associated with credit facilities amounting to RM59.7m (an average value of only RM2,600). While these schemes have been modest in value terms, they have played a key role in shaping bankers' perceptions of the CGC - a point which is taken up in the survey findings below.

(The CGC guarantees a variety of bank facilities, including, loans, overdrafts and export credit refinancing. For simplicity, however, this paper henceforth refers to "CGC loans" to represent all CGC-guaranteed liabilities.)

The importance of CGC loans within the overall financial spectrum in Malaysia has declined over the past decade - see Table 2.

The figures in Table 2 have to be interpreted with a degree of caution because the official definition of an Small Scale Enterprise (SSE) was revised in 1988, to cover registered businesses with net assets of less than RM500,000 (previously RM250,000). The CGC did not adopt the revised definition until 1989, when the PGS was introduced. If this change in definition is taken into account, CGC loans as a percentage of loans to SSEs (Column 5) has been relatively constant. However, the commercial banks have increasingly favoured larger borrowers; loans to SSEs (Column 3) had declined to 3.8 percent of total advances in 1993 from a peak of 8.4 percent in 1984.

Taking a somewhat broader perspective, the value of credit facilities extended by the core banking system (commercial banks and finance

companies) to SSEs had risen to over RM10bn by the end of 1993 (Bank Negara, 1993). The value of outstanding CGC loans, RM599m, represented only 6.0 percent of the core banking system's lending to SSEs at that time. Funding is also available from other sources, including publicly-backed development finance institutions (DFIs) and private leasing and factoring companies. Outstanding credit facilities to small firms from outside the core banking system were thought to be around RM9-10bn in 1993 (Lin, 1994).

To counter the drift away from bank financing, the CGC launched the New Principal Guarantee Scheme (New PGS) in early 1994. The New PGS is discussed in more depth after the presentation of the findings of an empirical evaluation of the "old" PGS.

The survey

Our objective was to conduct a pilot study of firms, based in Kedah and Penang, which had utilised the Principal Guarantee Scheme. The research methodology adopted by NERA (1990) and Pieda (1992) in evaluating the Loan Guarantee Scheme in the United Kingdom was tailored for the activities of the CGC.

The approach was to interview the firms, using a semi-structured check list of questions. The interviews were conducted over the summer of 1994, when both authors were based at University Utara Malaysia. A number of questions focused directly on the way in which the business was funded, clearly a sensitive topic for entrepreneurs. The responses often required further probing by the interviewer. This would not have been possible if postal questionnaires had been utilised.

A similar exercise was conducted with a representative of each borrower's bank; the survey participants were generally experienced lenders with considerable experience of dealing with the CGC.

Lists of guarantee recipients were obtained from the CGC, a total of 653 firms in Penang and 522 in Kedah. The population of CGC-backed firms reflects the fact that Kedah is oriented towards agriculture and general business, whereas Penang is a major centre of manufacturing. Our selected sample (25 in each State) mirrored the underlying population, in terms of:

Table 2. Commercial banks - outstanding loans: SSEs, all borrowers and CGC loans

Year	*SSEs* (RMm) (Col 1)	*Total Advances (All Borrowers)* (RMbn) (Col 2)	*SSEs as % of Total Advances* (%) (Col 3)	*CGC Loans* (RMm) (Col 4)	*CGC Loans as % of SSEs* (%) (Col 5)
1984	3,673	43.5	8.4	935.1	25.5
1985	3,473	50.3	6.9	852.3	24.5
1986	3,232	53.6	6.0	750.5	23.2
1987	2,984	52.4	5.7	670.6	22.5
1988	3,798	56.8	6.7	587.8	15.8
1989	3,712	67.1	5.5	511.7	13.8
1990	3,803	80.8	4.7	573.2	15.1
1991	4,048	97.2	4.2	603.0	14.9
1992	4,337	105.7	4.1	555.2	12.9
1993	4,426	117.3	3.8	599.2	13.5

Source: Bank Negara and CGC

size of loan; race of borrower; legal structure of the business; and, business sector. The final sample was 16 surviving firms in each State (Note 3), a figure which is a reasonable size for a pilot study. The composition of the sample is set out in Appendix 1.

The 32 firms interviewed were mainly retail or wholesale businesses, or engaged in construction or computer-related activities. The sample contains only three manufacturing firms, reflecting the small number of such firms in the underlying population.

An evaluation of the effectiveness of the PGS

The survey responses, presented in aggregate to preserve confidentiality, are grouped around three key areas:

a) the existing (and future) relationship between borrowers, banks and the CGC;
b) Finance additionality - whether the CGC loans provide additional or replacement finance;
c) Economic additionality - how much additional economic activity (increased sales, profits or employment) stems from the activities of companies which receive CGC loans.

a) Relationship: SMEs, Banks and CGC

In investigating the relationship between SMEs, lenders and the CGC, a useful starting point was to establish an accurate picture of how (and why) bank customers are directed to the CGC.

It was evident that the CGC has preserved a very low public profile, operating at arm's length from its ultimate clients, the SMEs. Only a small minority of borrowers (3 out of 32) knew of its existence before the guarantee was issued. The majority (25/32) learned of the CGC from their bankers and the remainder (4/32) became aware of the CGC through friends or the press. Most borrowers (26/32) had obtained the CGC funding through their usual bank, and they had relied on that bank to apply for the guarantee on their behalf.

There was no subsequent contact between the guarantee provider (CGC) and its SMEs, a situation which does not prevail in other countries

(Levitsky, 1993, p6). In such circumstances, the CGC cannot hope to influence the attitude or ability of the debtor to repay the loan or use the funding wisely.

In the absence of a relationship between the CGC and its SMEs, it is vital to engender a spirit of partnership between the lenders and the guarantee providers (Levitsky and Prasad, 1987). The creation of a fruitful partnership involves sharing the risks and rewards of the CGC loans in an equitable manner.

The interest rates on CGC loans were, as stated above, set at artificially low levels by the authorities in the 1980s. This policy distorted allocative efficiency. The banks' natural reaction was to ration credit as the return did not reflect the risk involved (Greenwald, Weiss and Stiglitz, 1984; Weiss and Stiglitz, 1981). Bank Negara had to set guidelines to force the commercial banks to lend. The imposition of financial penalties for non-compliance was hardly conducive to building a strong partnership. Furthermore, there was no evidence in our study that raising the interest margin (to 1.5 percent above BLR for the PGS) had resulted in the active promotion of CGC loans by the banks. The requirement to fulfil the quotas was often a critical factor in deciding which firms should be selected, a point which is amplified in the following sub-section.

Another important element in creating a partnership between the banks and CGC is the proportion of the loan that is guaranteed. In the case of the PGS, the standard level of cover was raised to 70 percent; the bankers were generally satisfied with the 30 percent level of residual risk, although this remained high by international standards. Whatever the chosen level of cover, however, confidence will be shaken if disputes arise over claims for repayment.

This aspect of the CGC's operations received scathing criticism by Levitsky and Prasad (1987, p56), who described the CGC as a passive institution which kept its liabilities to a minimum by rejecting claims on the grounds of technicalities. Information on the default rate on CGC loans is not publicly available, although the CGC does publish annual figures for loans

classified as non-performing (NPLs). In official loan schemes operating elsewhere, the payment of claims arising from NPLs would be almost automatic. In Malaysia, the situation is very different - see Table 3.

Table 3. Credit guarantee corporation liabilities

	*Non Performing Loans**			*Claims Processed*		*Claims Paid*
	Number	*Value (RMm)*	*%***	*Number*	*Value (RMm)*	*Value (RMm)*
	(Col 1)	*(Col 2)*	*(Col 3)*	*(Col 4)*	*(Col 5)*	*(Col 6)*
1984	n/a	114.8	12.3	232	1.32	0.13
1985	n/a	151.4	17.8	202	1.87	0.10
1986	12,208	201.2	26.8	210	1.99	0.25
1987	13,902	229.3	34.2	221	2.02	0.54
1988	12,709	239.5	40.7	228	2.74	0.65
1989	11,589	236.3	49.2	604	2.92	1.04
1990	10,515	223.2	38.9	909	9.10	1.19
1991	9,588	215.0	35.7	641	8.40	2.02
1992	8,467	209.0	36.0	301	3.90	1.30
1993	7,787	184.8	34.0	449	5.30	2.40

* Banks' estimate of potential bad debts

** Non Performing Loans as a percentage of outstanding CGC loans

Source: Kanbur, Boocock and Hwa (forthcoming)

Over the period 1986-1993, the CGC processed 3,563 claims, totalling RM36.4m; only 1,505, totalling RM9.3m, were settled. The remaining 2,058 claims, totalling RM27.1m, were either rejected by the CGC or withdrawn by the banks. The CGC had the right to reject claims if the quality of the initial appraisal, or the subsequent monitoring, of a loan was judged to be poor. This judgement was made on a retrospective basis, until new systems were implemented in 1989. However, the vast majority of claims in Table 3 arise from loans granted before that time.

On the basis of the figures in Table 3, it would appear that the banks, rather than public funds, have had to suffer the bulk of the losses stemming from bad debts. (The cost of operating the CGC has not been ascertained.) It was therefore anticipated that problems experienced in claiming under the

guarantee would be a frequent source of complaints in the pilot study. In fact, the bankers put forward a range of views on this topic.

It was generally acknowledged that much of the blame for non-recoverable loans lay at the banks' doors; nonetheless, there were requests for the publication of data on defaulters, to identify whether certain types of borrowers were prone to failure. On similar lines, it was generally accepted that the claims procedure had improved, but some participants (7/32) specifically requested that the CGC should speed up, and simplify, the processing of claims. Changes introduced in 1989, to phase out the CGC's ex-post evaluation of the banks' appraisal, should facilitate payments under the guarantee in future.

Finally, even though our survey dealt with loans granted under the PGS, there were numerous complaints from bankers about heavy losses suffered with the Hawkers and Traders (HPT) loans. The perception is that borrowers tend to treat HPT loans as grants rather than liabilities. As Table 1 demonstrated, these HPT loans play a comparatively minor role within the spectrum of CGC's activities. Nevertheless, the high level of bad debts sustained on these small loans, allied to an inability to receive payment under the associated guarantees, has made some bankers reluctant to direct any borrowers to the CGC.

b) Finance additionality

In the United Kingdom, the level of finance additionality generated by the LGS has been subject to close scrutiny. Initially, Robson Rhodes (1984) suggested that fewer than one half of the loans were genuinely additional, a pattern which was confirmed by NERA (1990). The latest survey (Pieda, 1992) indicated that 68 percent of the LGS lending was additional, a remarkable improvement. However, Pieda did point out that a high default rate was associated with cases of high finance additionality - 100 percent additionality often involved lending to entrepreneurs with no record of achievement, or to businesses with little prospect of generating high returns.

The situation in Malaysia is complicated by the Bank Negara quotas. Under pressure to meet targets, bankers may have utilised CGC loans to support inappropriate, high risk lending. Such cases constitute 100 percent finance additionality, but would have contributed to the high level of non-performing loans. Alternatively, the requirement to fulfil quotas may have tempted lenders to substitute CGC loans for conventional borrowing, ie, zero additionality. Chee (1986b, p75) even suggested that some bank managers had set up bogus firms with their friends and relations to take account of the cheap rates of interest on CGC loans in the 1980s.

In framing the rules for the PGS, a prime objective was to reduce the scope for using CGC loans as replacement finance. As a consequence, the guarantee issued under the PGS covered only that portion of the total bank package exceeding the amount considered to be adequately backed by collateral. The secured element of the bank finance did not require a guarantee. The outcome was that the risk inherent in CGC loans was significantly increased.

The influence of these changes was explored in our study.

Borrowers were asked: "If your application for a CGC loan had not been approved, or if the CGC has not existed, would you have been able to raise the funds in some other way?" The responses were as follows:

"yes" 19 firms, of whom: 10 claimed that they could have obtained conventional bank funding, with the CGC being chosen because the loan was cheaper (especially when the rate was capped over 1991/2); 4 would have approached another government-backed agency; and 5 would have tapped friends, relatives or illegal sources

"n/a" 4 firms stated that the funds were not really required at all

"no" 9 firms appeared to be cases where finance additionality was present.

The next step was to ask the bankers to estimate the amount that they would have been able to lend if CGC support had not been available. The responses of the entrepreneurs and their bankers were broadly comparable, although the latter were usually, in our judgement, more able to give an

accurate estimate of the borrowing capacity of their customers. The level of finance additionality was therefore mainly compiled from the bankers' responses, supplemented in a few cases by information from the SMEs which was not disclosed to their bankers - see Table 4.

Table 4. The CGC: finance additionality (all figures: RM000)

Firm (1)	*Funding Package from Bank*			*Bankmax (2)*	*Est Add (3) Amount (%)*
	Bank	*CGC Loan*	*Total*		
A	0	5	5	5	0 (0)
B	30	15	45	30	15 (100)
C	103	17	120	120	0 (0)
Aggregate Figures: Kedah					
16	335	508	843	501	342 (67)
Aggregate Figures: Penang					
16	831	602	1,433	1,078	355 (59)
Aggregate Figures: Total Sample					
32	1,166	1,110	2,276	1,579	697 (63)

Notes:

(1) The top three rows show the calculations for 3 companies selected at random.

(2) Bankmax = an estimate of the maximum available level of bank credit, if the CGC had not existed.

(3) Est Add = the estimated level of finance additionality, after taking into account what the bank could have advanced.

Table 4 reveals that the 32 firms received bank funding totalling RM2.28m, of which RM1.11m was supported by the CGC guarantee and RM1.17m was advanced through conventional bank lines. The PGS aims to provide "top-up" funds, hence the CGC loans totalling RM1.11m should represent 100 percent finance additionality. However, the bankers conceded that they could have granted facilities totalling RM1.58m, reducing the additionality of the CGC loans from RM1.11 to RM697,000 (63 percent of their value). Greater additionality was achieved in Kedah than Penang, 67 and 59

percent respectively, mainly because smaller loans in Kedah achieved 100 percent additionality.

There were 13/32 cases where discrepancies arose between reported and estimated additionality - 10 of these resulted in zero additionality. (For example, firms A & C in Table 4 could have raised the required funding under normal bank lines.) In most cases, the bankers would have been prepared to grant the facility unsecured, based on the borrower's sound track record, or they would have given a higher than normal value to the offered security. Alternatively, there were assets in the background which could have been used to secure the borrowing (Note 4).

Despite the comments above, the results for the PGS appear impressive, with 63 percent of the value of loans classed as additional finance for the recipients. This compares favourably with the LGS, where the NERA (1990) and Pieda (1992) studies showed additionality of 48 and 68 percent respectively. The statistics, however, are not comparable; Table 4 incorporates information relating to bank finance only, whereas the UK studies include data on non-bank funding.

It will be recalled that 9 borrowers claimed that they could have obtained non-bank funding. These claims seem plausible, as SMEs have increasingly sought funding from outside the commercial banks. In three cases, funds could have been obtained from MARA, another government agency; more generally, the borrowers were unwilling (or unable) to give precise information on the availability of non-bank funding, especially where illegal sources (loan sharks) were involved. Our best estimate is that the overall finance additionality for the sample was approximately 50 percent, compared to the 63 percent obtained in our analysis of bank finance alone.

The difficulty of establishing the level of additionality is confirmed when the topic is viewed from another perspective. The bankers were asked to state the principal reason why their customer was granted a CGC loan - see Table 5:

Table 5. Selection criteria for CGC Loans

High risk	2
Insufficient security	9
Sound track record	16
Cheaper interest rate	2
To meet quota	3
Total	**32**

These findings have to be treated with a degree of scepticism, because borrowers may be selected for CGC loans for a combination of reasons. However, the CGC loan probably yielded 100 percent finance additionality where the reasons are "high risk" or "insufficient security". The most common influence was a "sound track record"; this might suggest that creditworthy customers are selected until the quota is achieved and that, in the majority of such cases, the facility would probably have been granted unsecured. The quota was cited as the dominant factor in 3 instances; the bankers strongly hinted that CGC loans were simply offered to pre-selected customers until the quota was exhausted.

The behaviour of the bankers is thus at odds with the objective of the PGS. However, a cautious attitude on their part is understandable, as promotion prospects may be harmed by the incidence of bad debts. In the UK, as stated above, a high default rate was associated with cases of high finance additionality. The problem is to reconcile the differing objectives of the banks and SMEs. Neither the Loan Guarantee Scheme nor the CGC, for example, insist upon a specified level of personal commitment from the borrower; such a condition would reduce the incidence of default, but also tend to reduce finance additionality by denying finance to owners lacking resources.

c) **Economic Additionality**

This concept has two broad elements: the direct benefit for the SMEs in terms of increased employment, profits or output; and the indirect impact on the wider economy.

(Economic additionality should strictly be calculated with reference to those firms which receive "additional" finance. In view of the problems described above in establishing the level of finance additionality, this pre-condition has been ignored.)

The direct benefit to the recipients will depend, to a large extent, on the way in which the funds are utilised. In 29 of the 32 firms in the pilot study, the borrowers claimed that the finance was used in accordance with the original application. (Two borrowers bought goods for their own use, while the other simply onlent the funds at a higher rate of interest.) In each of the 29 cases, the funds were used for working capital purposes.

It was therefore more difficult to establish a direct link between the CGC loan and the subsequent progress of the firm, than if the funds had been used (say) to purchase fixed assets or take over another business. Furthermore, the provision of funds for working capital is probably less likely than capital expenditure to lead to sustainable rises in employment and output.

The majority of companies had increased **employment** since receiving the CGC loan; the 32 firms increased their workforce by 110 people (178 to 288 employees). However, significant increases in employment were confined to just two firms (see Table 6).

Table 6. CGC loans: impact on employment

Employment	*Number of firms*
a) Overall Position	
Increase	(*) 21
Decrease	1
No change	10
Total	**32**
b) Breakdown of 21 "Increases" (*) in Employment	
Increase from 2-4	14
Increase from 5-10	5
Increase from 11-15	2
Total	**21**

Even after the improvements shown in Table 6, there were fewer than five employees in 19 of the sample firms; small provisions shops providing a living for the owner and his family, for example, are not likely to provide a major boost for employment in the economy.

With regard to **profits and turnover**, most firms (27/32) reported enhanced performance, but they were unable to quantify the effect of the CGC loans. The Pieda study (1992: p67) produced very similar results - "almost all" of the firms which felt able to comment on this issue considered that output, employment and profit were higher than would have been the case without the LGS loan.

The second element of economic additionality takes account of displacement effects, ie, whether additional activity in the assisted firms translates into corresponding increases in the level of activity in the SME sector or the economy as a whole. The Pieda study (1992, Ch 8) again provides a helpful basis for comparison. Economic additionality was found to be low where service sector firms, especially retailers, were involved. Manufacturing firms generally have a greater economic impact and create jobs. At the national level, it was rare for LGS-assisted firms to export their products or substitute for imports. If the UK experience is repeated in Malaysia, the indirect economic additionality in our study would be expected to be low.

The sample firms were mainly retail or wholesale businesses, with few manufacturing firms. While most firms had attracted new customers since receiving the CGC loan, these customers were usually (22/32) from within a 50 mile radius of the firm's site and almost always (30/32) located within the State. Only two firms had captured any export business. This suggests that the CGC funding has largely displaced activity from one local firm to another.

Another strand of indirect economic additionality concerns the ability of small firms to create a more dynamic and innovative society. The evidence on the "dynamism" of LGS-assisted firms has been generally favourable. In our study, the findings were less encouraging.

We judged that a minority of well-managed firms were entirely worthy of CGC encouragement, having a very positive attitude towards expansion. For example, one firm specialising in homeopathic medicines had increased its workforce significantly and begun to export to the Middle East and the Eastern Bloc. By and large, however, the firms were content with modest progress, selling (or producing) fairly basic goods for a parochial market. Apart from the computer-related firms, the use of new technology was very modest.

The experience of the pilot study firms would probably be repeated in a wider study - firms engaged in "general business" dominate the present population of CGC-backed firms.

The new PGS

It is acknowledged that any conclusions drawn solely from our pilot study have to be tentative, in view of the sample size. However, secondary data produced by the CGC and Bank Negara have tended to confirm the survey findings. Overall, the CGC's effectiveness in meeting the needs of SMEs, banks and the wider economy appears to have been somewhat limited.

Although its past performance does not offer convincing evidence that it is equipped to face new challenges, the CGC has been given a high profile within official efforts to encourage the growth of SMEs. There is certainly a perception in official circles that viable SMEs continue to be denied funding, hence the successful implementation of the New Principal Guarantee Scheme is critical.

a) The Terms and Conditions of the Scheme

The New PGS is designed to cater for the needs of larger companies, especially those operating in priority sectors specified by the Government, notably the manufacture of high-technology and resource-based products. The value of credit facilities eligible for guarantee and the level of guarantee coverage were increased. (The provision for higher guarantees to selected

borrowers was welcomed by bankers in the pilot study.) The New PGS is available through finance companies, as well as banks.

The interest margin was raised to 2.0 percent over BLR, while the guarantee premium was left unchanged. The total cost for borrowers is now comparable with other guarantee schemes across the globe. As a consequence, decisions on utilisation, by borrowers and lenders alike, should increasingly be taken on the basis of rational economic and risk factors (Kanbur, Boocock and Hwa, forthcoming). The authorities appear to have abandoned their policy of fixing interest rates for SMEs at below market rates.

The guarantee under the New PGS can be used in two ways. First, it can cover all the facilities made available at the time of approval; the guarantee will cover 70-90 percent of the borrowing. Alternatively, the lender can take the secured part of the lending package outside the arrangements with the CGC (as with the "old" PGS). Thus, in the case of a firm wishing to borrow RM200,000, with collateral valued at RM100,000, the bank could choose to have all the borrowing guaranteed by the CGC or simply the excess over the security. In the former case, where the CGC loan is backed by collateral, the proceeds would be shared between the bank (or finance company) and CGC in relation to their respective liabilities. With the inclusion of such loans, the CGC's portfolio of loans should be less risky (with a proportion of loans being backed by collateral).

The terms and conditions of the Scheme were announced only after extensive consultation with the financial community. In addition, lenders are encouraged to participate by a reduced weighting for CGC loans in the calculation of their capital adequacy ratios, as well as simplified administration procedures.

The initial take-up of the New PGS has been extremely impressive (see Table 1). In the period March-December 1994, 3,146 loans were granted, with a total value of RM530.1m. A detailed breakdown of these figures is not available, but the increase in uptake has probably stemmed from a combination of factors: the use of the guarantee to cover all borrowing (as

described above) rather than the excess over the value of collateral - the average value of each loan has risen sharply; the provision of loans by finance companies as well as banks; and the conversion of conventional bank or "old" PGS loans to the new Scheme.

b) The new PGS: an improved Loan Scheme?

The objectives of the CGC have never been clearly defined (or publicised). The CGC has "social" and "commercial" responsibilities, attempting to satisfy the requirements of firms ranging in size from "hawkers and traders" to larger firms operating in the government's priority sectors, as well a continuing obligation to assist Bumiputera borrowers. The New PGS is only one of a portfolio of schemes. Its stated objective is to achieve high levels of uptake and economic additionality, but the issues of finance additionality and the likely default rate have not been addressed.

Notwithstanding this lack of clarity, the New PGS is examined to assess whether its introduction is likely to improve CGC's effectiveness in each of the critical areas covered in the pilot study, ie, the relationship between lenders and the CGC, and finance and economic additionality.

The relationship between lenders and the CGC appeared to be improving, although there were still some areas of dispute, notably the claims procedure and the influence of the small HPT loans. (The bankers interviewed would welcome the scrapping of the latter.) The introduction of the New PGS was recognised as an ideal opportunity to further strengthen the relationship between the CGC and the financial institutions. If the initial uptake of the Scheme is to be sustained, financiers must be convinced that the CGC will honour its guarantees in the event of default. The lenders will still be at risk for between 10 and 30 percent of New PGS loans.

The quotas for CGC loans have been retained, with penalties for non-compliance, despite their potentially harmful effect on the relationship between the CGC and the lenders and even though they do not appear to have been helpful in achieving finance and economic additionality. The imposition of official guidelines might have been required to give impetus to

the CGC's operations in its early years, but they may now have served their purpose. If the New PGS is a "good product" for borrowers and lenders alike, its usage could be determined by market forces (a suggestion which was put forward by bankers in the pilot study).

The degree of **finance additionality** found in the pilot study for the PGS was questionable, mainly because it proved difficult to isolate the influence of quotas. With the retention of the quota system, it is difficult to judge whether additionality will improve or decline for the New PGS. The higher level of guarantee cover and improved interest margin must encourage banks and finance companies to voluntarily direct high risk SMEs to the new Scheme. Nevertheless, it is difficult to account for the surge in borrowers from an SME sector which remains fragmented and traditional in outlook. The responsibility for selecting firms for CGC support remains with the lenders, and the temptation to use New PGS loans as replacement finance is still present.

Turning to **economic additionality**, the pilot study (and secondary) data suggested that CGC loans enable SMEs to increase employment, profits and output. However, the indications were that local displacement effects are high, export activity or import substitution is low and innovation is infrequent. For the New PGS to achieve a higher degree of economic impact, the CGC's portfolio of companies will have to be radically altered. If, for example, innovative firms in the manufacturing sector receive support, the outcome would be greater export activity and improved linkages between large and small firms. Unfortunately, detailed information on the type of companies benefiting from New PGS loans is not yet available.

The key problem, as discussed in the sub-section on finance additionality, is to reconcile the differing objectives of the various parties - the CGC, banks, SMEs and the authorities. For example, the exclusion of certain types of propositions (particularly retailers) would offer higher economic additionality, but a concentration on high risk innovative companies would tend to result in increased bad debts.

Previous schemes operated by the CGC appear to have experienced a high proportion of non-performing loans, without achieving high levels of finance and economic additionality. Whether the New PGS will succeed in encouraging the growth of high risk enterprises, with a more equitable distribution of the costs between lenders and public funds, will only be determined after the it has been in operation for a number of years.

c) The implications for other Guarantee Schemes

The balance between helping high risk enterprises, which cannot obtain conventional bank funding, and loan losses will always be a delicate one. The successful operation of any loan scheme therefore has to be based upon mutual co-operation between the guarantee provider, financial institutions, the authorities and SMEs. All parties have to recognise their rights and responsibilities. The terms and conditions of any government-backed loan scheme will contain an element of subsidy, but the costs of operating the scheme have to shared equitably.

The experience in Malaysia also suggests that attempts to distort market forces, by imposing quotas, have not resulted in high levels of finance and economic additionality.

Notes

1: Definition of "Small" Business

The article henceforth refers to SMEs as the generic term for smaller enterprises, although there are no generally accepted limits (in relation to employees or turnover) at which a small firm becomes medium-sized or large. In Malaysia, the definitions used by the Ministry of International Trade and Industry (MITI) are generally accepted; a small firm is one with less than (RM: Malaysian Ringgit) RM500,000 shareholders' funds, with 2.5m the limit for a medium-sized firm. Adopting these definitions, the CGC restricted its facilities to small firms until 1994, when medium-sized firms became eligible.

2: The "Quota" System

Malaysia is believed to be unique in operating a formal quota system, although various methods are employed in other countries to encourage banks to participate in their loan schemes. In Korea, for example, the banks contribute annually to a fund from which loans are granted.

3: The Sample

The problems of conducting research in a mixed-race, multi-lingual society should not be under-estimated. Furthermore, SMEs in Malaysia have little or no experience of requests for interviews from academics. The reasons for non-participation by firms in the selected sample (18 out of 50) illustrate these problems: the research team were unable to locate 8 firms (mostly in Kedah), as they were not on the telephone and maps of rural Malaysia are notoriously inaccurate; one borrower had gone overseas, and another had closed his shop without leaving a forwarding address; 2 borrowers had ceased to trade and were in default; and, finally, six firms (mostly Chinese) were not willing to participate in the survey. Non-participants were not replaced, mainly because of constraints on time and resources.

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Given these problems in contacting surviving firms, the research team (and the CGC and the firms' bankers) decided that it would have been impossible to include defaulting firms in the sample.

4: Security for CGC Loans

According to CGC records, only 19 of the 32 borrowers had lodged security in support of the total bank facilities granted at the time the guarantee was approved, whereas 30 of the borrowers stated that they had given collateral. This anomaly stems from the fact that banks in Malaysia tend to insist upon a personal (unsupported) guarantee from the borrower or the assignment of contract monies, even if no tangible security is available.

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Appendix 1. The number of CGC loans in Kedah and Penang

	Kedah				*Penang*			
	Population		*Sample*		*Population*		*Sample*	
	Number (N)	*%*	*N*	*%*	*N*	*%*	*N*	*%*
A: Racial Composition								
Bumiputra	255	49	10	62	243	37	6	37
Chinese	256	49	5	31	384	59	10	62
Indian	11	2	1	6	24	4	0	0
Other	0	0	0	0	2	0	0	0
Total	522	100	16	100	653	100	16	100
B: Business Sector								
Agriculture	20	4	0	0	8	1	0	0
Manufacturing	33	6	2	12	77	12	1	6
General Business	469	90	14	88	568	87	15	94
Total	522	100	16	100	653	100	16	100
C: Legal Structure of Firms								
Limited Company	55	11	1	6	125	19	2	12
Partnership	94	18	6	37	119	18	2	12
Sole Proprietor	373	71	9	56	409	63	12	75
Total	522	100	16	100	653	100	16	100
D: Loan Size (RM000)								
Up to 5	14	3	0	0	25	4	1	6
6-10	98	19	1	6	82	13	0	0
11-30	175	34	7	44	150	23	4	25
31-50	76	15	3	19	117	18	4	25
51-100	73	14	4	25	122	19	2	12
101-200	58	11	1	6	91	14	2	12
200 plus	28	5	0	0	66	10	3	19
Total	522	100	16	100	653	100	16	100

Source: CGC