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Corporate credit guarantees in Asia[1]

In many Asian countries, government institutions have played an important role in guaranteeing SME loans. Nevertheless, they have also exhibited lacklustre operating profits in recent years. Two episodes of failures involving companies offering credit guarantees highlight the importance of sufficient capitalisation and prudent risk management, as well as the difficulty borrowers have in making a transition from credit guarantees.

JEL classification: G200, G220, G280.

Credit guarantees are an important part of corporate financing in Asia, especially for small and medium-sized enterprises (SMEs). Adequate financing of SMEs is often constrained by their relatively high credit risk and the conservatism of domestic investors. To help solve this problem, public or private institutions in many Asian countries have provided credit guarantees. However, government provision of credit guarantees has the potential to distort incentives and diminish efficiency. If assured of guarantees, banks might be less thorough in screening and monitoring when they extend loans to firms, enabling firms to launch riskier projects and be less prudent in their business operations. Moreover, while the provision of public credit guarantees can stabilise the financial system during recessions, government institutions might be tempted to use such guarantees to boost economic activity during expansionary phases.

This article focuses on the role and performance of government and private institutions in the provision of corporate credit guarantees in Asia, and discusses the lessons from the failures of credit guarantee institutions. In many Asian countries, while government institutions have supplied a sizeable amount of credit guarantees for corporate debts, such as SME loans, collateralised bond obligations (CBOs) and collateralised loan obligations (CLOs), they have mostly exhibited poor underwriting performance in recent years. Two cases of credit guarantee company failure in Singapore and Korea highlight, respectively, the importance of sufficient capitalisation and adequate risk

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management, and the difficulty borrowers have in making a transition from credit guarantees. Based on this, it is argued that government policy should take into account the effects of guarantees on borrower and lender incentives with a view to increasing the efficiency of the guarantee system. Furthermore, the experience underscores the importance of complementing government policies with the promotion of financial market infrastructure, such as credit rating systems and accounting standards.

The next section reviews the roles and performance of public credit guarantee institutions in six Asian countries, and the securitisation of SME debt with government support in Japan and Korea. The following section discusses the lessons from the failed guarantee companies in Korea and Singapore. The final section concludes.

Corporate credit guarantee institutions in Asia

In many Asian countries ...

Credit guarantees [2] take the form of either guarantees provided by public institutions or commercial guarantees extended by private companies. Large government institutions have provided a sizeable amount of credit guarantees to SMEs – an important sector in all Asian economies – in Indonesia, Japan, Korea, Malaysia, Taiwan (China) and Thailand. [3] By contrast, many private companies supply the largest proportion of credit guarantees in China, (see Box 1). Recently in Japan, Korea and Singapore, governments have extended credit enhancements to SME debt securitisations.

Government agencies for corporate loan guarantees

... government institutions have guaranteed corporate debt ...

In the six countries considered below, business enterprises often lack the collateral for loans. As a result, credit guarantee institutions have been established to help enterprises obtain funds from banks by guaranteeing payment of loans, thereby seeking to contribute to a more balanced development of the national economy.

Japan has a unique two-tier credit supplementation system. Fifty-two independent Credit Guarantee Corporations (CGCs), established in each prefecture and five cities, assess the creditworthiness of local SMEs and guarantee bank loans to them. Japan Finance Corporation for Small and Medium Enterprise (JASME), established in 1953, supports the CGCs by reinsuring about 70–80% of their risks and by extending low interest loans to CGCs. JASME also supports SME debt securitisation. The central government supplies all of JASME's capital.

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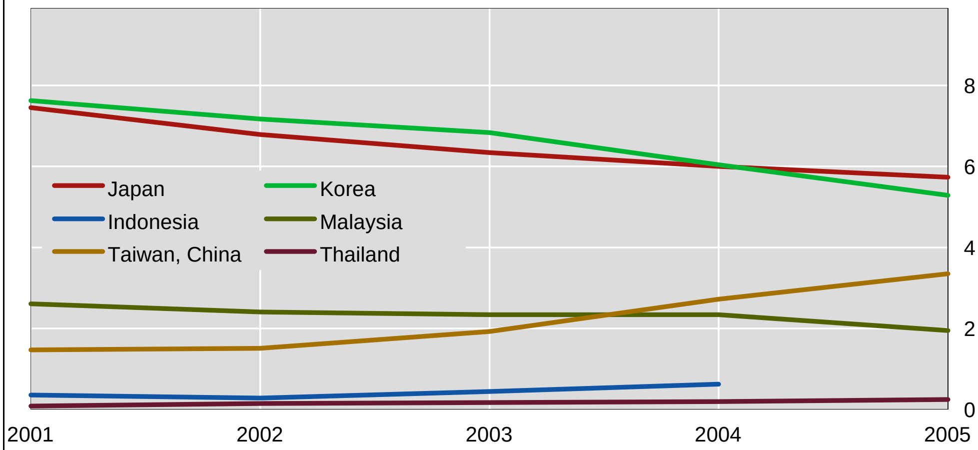
[2] Credit guarantee (sometimes known as financial guarantee) contracts require the issuer to make specified payments to reimburse the holder for a loss when a debtor fails to make payment when due (IASB (2004)). In this article, I use the term "credit guarantee" to refer to "financial guarantee".

[3] SMEs account for over 99% of all businesses in Japan, Korea and Thailand. They also account for 54% of total value added in Japan, and 51% of total production in Korea (Chin and Park (2005), Nuonome (2005), Tawee (2005)). Taiwan (China) is hereinafter referred to as Taiwan.

Credit guarantees outstanding in selected Asian countries

As a percentage of GDP



Note: For Japan, outstanding guarantee liabilities of CGCs; for Korea, sum of outstanding guarantee liabilities of KCGF and KOTEC; for Indonesia, sum of outstanding guarantee liabilities of Perum Sarana and acceptance of insurance by Askrindo.

Sources: IMF; ACSIC questionnaires; individual annual reports; BIS calculations. Graph 1

Korea has two corporate credit guarantee institutions: Korea Credit Guarantee Fund (KCGF) and Korea Technology Credit Guarantee Fund (KOTEC). Both are non-profit financial institutions whose paid-in capital comes from contributions by the government and banks. KCGF provides guarantees mostly for SME loans, while KOTEC covers mainly technology-oriented SMEs.

Indonesia also has two credit guarantee institutions for SMEs and credit cooperatives: Perum Sarana Pengembangan Usaha (Perum Sarana) and PT Asuransi Kredit Indonesia (Askrindo). Perum Sarana was established in 2000, and is 100% government-owned. Askrindo was established in 1971 and is owned by Bank Indonesia (55%) and the Ministry of Finance (45%).

In Malaysia, Credit Guarantee Corporation Malaysia Berhad (CGCMB) was incorporated in 1972, and the current shareholders are Bank Negara Malaysia (BNM) (79%) and commercial banks and finance companies (21%). The government makes loans to CGCMB through BNM at favourable rates for financial assistance.

Taiwan's Small and Medium Business Credit Guarantee Fund (SMEG) was established in 1974 as a non-profit legal entity. The central and local governments hold a 81% share in the entity.

Finally, the Small Industry Credit Guarantee Corporation (SICGC) in Thailand is a state-owned enterprise, established in 1991. The Ministry of Finance in Thailand holds a 93% share.

... on a large scale

The importance of these institutions in their respective economies and financial systems can be gauged by the ratio of credit guarantees outstanding to GDP (Graph 1). The total guarantee exposure is relatively high for Japan and Korea, at over 5% of GDP, but relatively low for Indonesia and Thailand, below 1%. While the ratio has been decreasing over the past five years for Japan, Korea and Malaysia, it has increased steadily over the same period in Indonesia, Taiwan and Thailand.

Institutional characteristics and operating results

Government institutions differ in terms of guarantee coverage ...

Three measures – guarantee coverage, guarantee fees, and leverage – can be used to highlight the main characteristics of these institutions (Table 1). The guarantee coverage ratio measures the share of qualifying loans guaranteed by an institution. This ratio generally ranges between 50 and 90% for the entities under review, with the exception of Japan, where local CGCs guarantee 100% of the loan amount. Guarantees of loans are usually partial so as to ensure that banks retain some incentive both to screen and to monitor loans.

... guarantee fees ...

Second, the annual guarantee fee represents the amount the institutions charge every year as a percentage of the guaranteed amount. The guarantee fee has the potential to partially reflect the riskiness of individual loans. Four of the agencies reviewed – KCGF, KOTEC, Perum Sarana and SMEG – have adopted a risk-based fee system in which the fees vary according to metrics of credit risk. In general, the guarantee fee appears quite comparable across countries, at 0.5–2.0% of the guaranteed amount. At the same time, the level of the fees seems insufficient to cover costs in most countries, as we will discuss further when considering the operating results of the institutions.

... and leverage ...

Finally, the leverage ratio − defined as the ratio of credit guarantees outstanding to the amount of the institution's capital (net worth) − is presented in the last column of Table 1. It provides a good indication of the amount of risk taken by the institutions, and ranges from around 4 for the Malaysian and Thai

Characteristics of corporate credit guarantee institutions

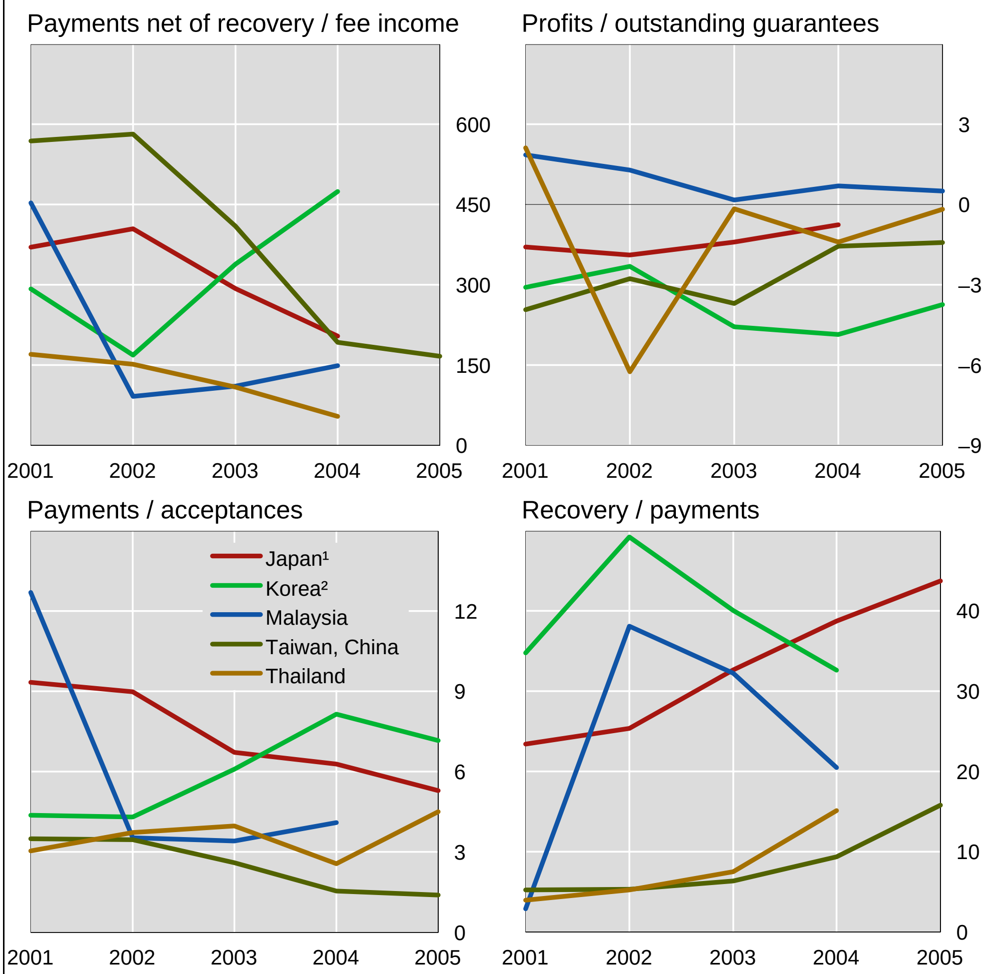
	Institution	Coverage ratio	Guarantee fee[1]	Maximum (actual) leverage ratio
Japan	JASME	70–80%	0.87%	No maximum (19.1, March 2005)
	CGCs	100%	1.25%,[2] 1.35%[3]	35–60 (18.6, March 2005)
Korea	KCGF	70–90% (usually 85%)	0.5–2% (risk-based)	20 (9.8, end-2005)
	KOTEC	70–90% (usually 85%)	0.5–2 % (risk-based)	20 (14.4, end-2005)
Indonesia	Perum Sarana	Max 75%	0.5–1.5% (risk-based)	20 (22.2, end-2004)
	Askrindo	50–70%	0.8–2%	. (6.9, end-2004)
Malaysia	CGC	30–100%	0.5–2%	No maximum (4.3, end-2005)
Taiwan, China	SMEG	70–100% (usually 80%)	0.75%, 1%, 1.25%, 1.5% (risk-based)	20 (20.6, end-2005)
Thailand	SICGC	Maximum 50%, or 50% of actual loss[4]	1.75%	5 (4.6, end-2005)

[1] Per annum. [2] With collateral. [3] Without collateral. [4] Depending on facilities.

Sources: ACSIC questionnaires; individual annual reports; BIS calculations. Table 1

Operating results of credit guarantee agencies

In per cent



[1] JASME and NFCGC. [2] KCGF and KOTEC.

Sources: ACSIC questionnaires; individual annual reports; BIS calculations. Graph 2

institutions to around 20 for institutions from Japan, Indonesia (Perum Sarana) and Taiwan.

... but generally have shown ...

Most of the guarantee institutions have posted poor performance in recent years. Graph 2 summarises this performance on the basis of the following four ratios: payments (for defaulting credits) net of recovery divided by fee income; profits divided by outstanding guarantees; payments divided by newly accepted guarantees; and recovery divided by payments.

... lacklustre underwriting performance ...

Underwriting performance is measured by the ratio of payments net of recovery to guarantee fee income (Graph 2, upper left-hand panel). This is similar to the combined ratio used by industry analysts in the non-life insurance industry,[4] although it provides a more generous view because it does not include operating expenses in the numerator. In most countries, this ratio is

[4] The combined ratio indicates claims and operating expenses as a percentage of premiums. A ratio lower than 100% indicates an underwriting profit, ie premiums more than cover the cost of claims and operating expenses. A ratio higher than 100% indicates an underwriting loss.

considerably higher than 100%, implying that the institutions incur underwriting losses.

... and low profitability

The measure of profit per dollar of outstanding guarantee exposure, presented in the upper right-hand panel of Graph 2, captures the profitability of the guarantee institutions.[5] Note that, compared to the measure of underwriting performance, profits also incorporate investment income, other income and operating expenses. Except in Malaysia, where the ratio has been close to zero in recent years, the institutions have posted losses on their guarantee operations. Moreover, the level of profitability appears generally consistent with the underwriting performance of each country. The agencies in Korea have shown particularly weak and deteriorating profitability since 2002, partially due to the surge in the issuance of credit guarantees to weak venture firms in 2001.

The ratio of the payment of claims within a year to the amount of newly accepted guarantees within the same year can be used as a measure of the risk profile of credits accepted by the guaranteeing institution (Graph 2, lower left-hand panel). This ratio has been relatively high for Japan and Korea, at over 5% for the past few years, but has been low for Taiwan, at under 2%.[6]

Finally, the ratio of recovery to payments reflects not only the country-specific level of loss-given-default for loans but also how vigorously banks attempt to reclaim their assets in default. This ratio ranges between 3 and 50% for the institutions considered (Graph 2, lower right-hand panel). Since the loans carry at least a partial government guarantee, banks are likely to have a diminished incentive for diligence in this regard. As a result, many guarantee institutions have taken measures to induce banks to recover more from the defaulted loans. For example, CGCMB introduced recovery incentives such as rebates on recovery proceeds and sharing of legal fees for claims already paid by CGCMB. Under the Risk Participation Scheme in Thailand, SICGC is liable for 50% of the actual loss from the loan default, and banks for the rest. The recovery ratio has tended to increase since the beginning of the sample in 2001, suggesting that the institutions may have been making a greater effort to reduce losses.[7]

To compensate for the operational losses of these institutions, the shareholders have continued to contribute capital. In Japan, the CGCs' capital has been replenished by local governments, financial institutions and trade organisations. The central government has also contributed every year to JASME to compensate for its losses. In Korea, banks are currently required to contribute 0.25% per annum of their corporate loan balances in certain

[5] While public credit guarantee institutions do not necessarily aim at generating positive profits, the measure can nonetheless reflect in part the efficiency of operations.

[6] This ratio is subject to an "expansion bias". That is, since loans do not deteriorate immediately, when the new acceptance of guarantee exposures grows fast, the comparison of acceptances and payments within a year may underestimate the default risk.

[7] One caveat to this conclusion is that there is a lag between the payment of the guaranteed amount and recovery, so that the ratio may not provide a precise picture of the recovery effort in a particular year.

Box 1: Credit guarantee companies in China

In contrast to the other countries examined in this special feature, China does not have a centralised government institution providing credit guarantees to SMEs. As a result, only about 2.6% of all China's SMEs benefited from credit guarantees as of the end of 2005. Nevertheless, China does have about 3,000 local credit guarantee companies. China's first professional guarantee organisation was established in 1993. Since then, the SME credit guarantee industry has developed rapidly, especially following the measures introduced in August 2000 to encourage the further development of the credit guarantee system.

The number of guarantee organisations increased from 203 in 2000 to 2,914 at the end of 2005.[1] These companies operate at either the provincial level or the city level. About two thirds of them are privately owned, while the others are either fully or partly owned by local governments. The total amount of capital for these companies amounted to CNY 81.5 billion, with around a quarter being provided by local governments. The amount of SME loans guaranteed by the credit guarantee companies has increased rapidly since 2000. The amount of guarantees outstanding reached CNY 322.7 billion in 2004, and CNY 467,387 billion in 2005, or 2.0% and 2.6% of GDP in 2004 and 2005, respectively.

The guarantee companies in China provide different types of guarantees, including credit guarantees for SMEs, housing mortgage guarantees and export finance guarantees. However, credit guarantees for SMEs have been the most important line of business. Although the credit guarantee industry has expanded quickly, most of the guarantee companies are reportedly suffering from insufficient funds and accumulating losses.[2] As a way to overcome these problems, the National Development and Reform Commission in China has proposed establishing a National Fund for Development of Credit Guarantees for Private Enterprises (NCG). According to the plan, NCG is expected to attract funding from loans and grants from international donors and capital contributions by private enterprises, and its business will be to support credit guarantee companies through equity investment, loans, co-guarantees and re-guarantees.[3]

[1] Zhou (2006). [2] Invest in China (2005). [3] ADB (2005).

categories to KCGF and 0.15% to KOTEC. The Korean government also contributes to KCGF and KOTEC every year from the national budget.

How does the performance of the guarantee institutions relate to their distinguishing characteristics described above? For one, there appears to be an inverse relationship between profitability and the degree of guarantee coverage. This suggests that lower-quality loans tend to be accepted the greater the guarantee. For instance, in 2004 observations across institutions, there is a statistically and economically significant positive correlation (0.43) between the coverage ratio and the ratio of payments out of newly accepted claims. In addition, there is (weaker) evidence that greater risk-taking through higher leverage in guarantee extension is associated with greater realised losses; the coefficient of correlation between the leverage ratio and the ratio of profits to credit guarantees outstanding in 2004 is –0.16.

Securitisation of SME loans with public credit enhancements

Government also provides credit enhancements …

In addition to directly guaranteeing individual loans, credit guarantee institutions can facilitate their securitisation and provide so-called credit enhancements to these securitised products. The credit quality of asset-backed securities (ABSs) depends on the performance of the underlying assets and the credit enhancements attached. To protect investors from the credit risk of the underlying assets, ABS structures typically include several kinds of credit enhancements.[8] Through credit enhancements, ABS originators can attain a higher credit rating and a lower rate of interest on the related bond issues.

... to SME debt securitisation ...

CBOs and CLOs backed by SME debt have gained popularity as an asset class globally in recent years.[9] SME CLOs have been used in Europe since the 1990s, especially actively in countries such as Germany and Spain. In Asia, where the market is of more recent vintage, only a few countries have actively used SME CBOs and CLOs to date. In particular, government institutions in these countries have played an important role in providing credit enhancements to these early securitisations. In this subsection, we focus on SME CBO and CLO transactions in Japan and Korea.[10] Park et al (2005) project that, between 2008 and 2013, there will be increasing demand for securitisation of SME loans in Asian countries, most of which seems likely to occur in China, Japan and Korea.

... actively in Japan ...

In Japan, CLOs backed by loans to SMEs have been growing fast for the past several years, with a large part of them being initiated and guaranteed by the government institutions. Local governments such as the Tokyo Metropolitan Government (TMG) have been very keen to support CLO and CBO issuance by SMEs. Between 2001 and 2004, TMG issued CLOs and CBOs five times to provide in total over JPY 380 billion to approximately 9,000 companies. Since then, JASME has started Securitisation Support Programs. In particular, JASME provides partial guarantees of new unsecured loan claims that banks extend to SMEs and supports their securitisation effort. The Bank of Japan also purchased SME-related ABSs and asset-backed commercial paper in 2003 and 2004. This policy was intended to ensure the smooth flow of corporate finance to SMEs and improve SMEs' access to credit by accelerating the development of ABS markets (Hirata and Shimizu (2004)).

... and Korea

In Korea, following the financial crisis, securitisations were actively used for corporate financing, with guarantees provided by KCGF, KOTEC and the Small Business Corporation (SBC). The first issuance of CBOs by SBC in 2000 was driven primarily by the urgent need for the government to provide funds to SMEs and alleviate extremely tight credit conditions. Since then, issuance has become quite frequent with the range of underlying assets expanding sharply, and CBOs have been issued in both domestic and foreign currencies. From 2000 to 2005, SBC issued CBOs based on SME debts totalling KRW 2 trillion (approximately USD 2 billion) to almost 700 SMEs.

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8 Internal credit enhancements include excess spread, subordination, overcollateralisation, put-back options and originator's guarantees. External credit enhancements refer to financial guarantees, called "wraps", provided by banks or financial guarantee institutions, and short-term loans provided by banks to special purpose vehicles with guarantees for these loans offered by credit guarantee institutions.

9 For the structures and techniques of CBOs and CLOs in Asia, see Gyntelberg and Remolona (2006).

10 Singapore also launched in 2006 an SME loan securitisation called SME CreditAssist (Singapore) Ltd, with the equity tranche (unrated subordinated notes, 17%) fully subscribed by its sponsors, the Standards, Productivity and Innovation Board of Singapore and the Development Bank of Singapore. For details, see Gyntelberg and Remolona (2006).

Such CBO issuance was strongly dependent on credit enhancements. The average credit ratings of the entities behind the SBC-issued CBOs were between B+ and BB–, well beyond the risk appetite of many investors. While around 15–20% of the CBOs issued by SBC consisted in equity tranches, this was not enough to ensure a AAA rating for senior tranches. Thus, banks and guarantee institutions provided additional credit enhancements. For example, the Korea Development Bank, SBC, the Industrial Bank of Korea and the Japan Bank for International Cooperation have provided guarantees to senior notes issued by securitised funds to help foreign capital finance Korean SMEs.

Policy lessons from troubled guarantee companies

As discussed above, inherent incentive and informational problems complicate the management of corporate credit guarantee systems. This section attempts to summarise the policy lessons drawn from two specific examples of guarantee schemes that ran into trouble in the late 1990s. These lessons can be broadly classified into those relating to the internal risk management and governance of the guarantee system, and those relating to the function of the system in the overall financial structure of an economy.

Internal risk management and governance[11]

Guarantee systems offer a facility to spread risks across a large number of borrowers, but are not fail-proof. To be sure, individual lenders may not be able to achieve a sufficient degree of diversification on their own because of limits to their size or their geographical scope, or their inability to withstand losses over the business cycle. At the same time, guarantee schemes can be vulnerable to concentration risk, as illustrated by the recent failure of Asia's first regional guarantee company, ASIA Ltd, established in Singapore (see Box 2).

The experience of ASIA Ltd emphasises ...

The failure of ASIA Ltd can be traced to a number of weaknesses in its structure. First, ASIA Ltd was structured to obtain an A credit rating, which proved to be too low to withstand the Asian financial crisis and conduct credit guarantee business outside the region. Second, in the aftermath of the crisis, a dispersed shareholder base made it difficult to coordinate its recapitalisation. Finally, the concentration of its business in selected Asian countries implied high correlation risk.

... the importance of strong capitalisation ...

Since 2003, the Asian Bond Market Initiative (ABMI) Working Group on Credit Guarantee and Investment Mechanisms under ASEAN+3 has been studying how best to set up a regional guarantee mechanism which is commercially viable and publicly owned (ABMI (2006)). The new plan by ABMI attempts to avoid some of the problems that contributed to the failure of ASIA Ltd. The new regional guarantee entity will aim at having a stronger capitalisation than ASIA Ltd, in order to obtain a AAA rating. In addition, plans are for the entity to be housed within the ADB, or set up as an independent multilateral organisation with clear procedures for recapitalisation, either of

[11] The information in this subsection is mainly drawn from Oh and Park (2004) and Standard & Poor's Rating Services (2001).

Box 2: Two cases of credit guarantee company failure in Asia

Asian Securitisation and Infrastructure Assurance Ltd (ASIA Ltd) was set up in 1995 in Singapore as Asia's first regional credit guarantee company. ASIA Ltd invested mostly in sovereign, asset-backed, infrastructure and financial institution debt obligations. Geographically, 78% of its portfolio was within China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines and Thailand.① Its major shareholders were both private and public entities.② The financial crisis in 1997 put the company under severe stress. Despite paying out only a limited amount of claims between 1997 and 2001, non-investment grade exposures reached about 40% of its risk portfolio. This resulted in a downgrade of its liabilities in January 1998, and its shareholders were unable to agree on the terms of a recapitalisation plan, owing to different views over the broadening of its geographical coverage. Subsequently, the company ran down its assets and was liquidated in 2005.

The Korea Guarantee Insurance Company and the Hankook Fidelity and Surety Company had guaranteed corporate bonds issued mainly by large corporations in Korea in the mid-1990s. The financial crisis and the surge in corporate defaults in 1997 and 1998 led to their failure. They were subsequently merged into the Seoul Guarantee Insurance Company in November 1998, after the injection of government funds.

① The remaining portfolio was in the United States, the United Kingdom, Japan and the Inter-American Development Bank. ② CapMAC Asia Ltd, Apmac Investment Pte Ltd, Asian Development Bank, Employees Provident Fund of Malaysia, American International Assurance Co Ltd, Kookmin Bank, etc.

which will allow coordination problems in the event of recapitalisation to be more easily resolved.

... and adequate risk management

Given the high level of correlation risk within Asia, the insurance premiums charged for regional guarantees will need to correctly incorporate the correlation risk. Moreover, the capital buffer should be large enough to withstand a large negative regional shock. In this sense, it may be desirable for the new plan to take a conservative approach and strictly limit exposures to each country based on their ratings (Oh and Park (2004)).

Another potential problem is how to maintain equitable coinsurance payments among different countries. Persistent losses to the system generated by exposures to a specific country might test the political willingness of other participant governments to inject new capital on the basis of original shareholdings. In the medium term, the country that is experiencing stress might be forced also to lead the recapitalisation effort.

Role in financial structure

Another set of issues relates to the need for guarantee programmes to be structured in a way that mitigates problems of moral hazard and that provides incentives for borrowers to graduate to guarantee-free financing over time. Here it is important for policymakers to encourage the development of a private corporate credit guarantee industry, supported by the development of financial market infrastructure including credit rating systems and accounting standards.

Failures of credit guarantee companies in Korea ...

The experience in Korea after the closure of two guarantee companies in 1997 and 1998 highlights the risks of the excessive dependence of borrowers on credit guarantees (see Box 2). Immediately after the financial crisis began in 1997, Korean banks and two private guarantee companies were unable and unwilling to provide new guarantees on corporate bonds. This happened despite an emergency measure under which the deposit insurance system protected almost all liabilities of Korean financial institutions, including the credit guarantees provided by the two private companies. Later, in August 1998, the deposit insurance system discontinued support for bonds guaranteed by the two companies.

As a result of the unavailability of bond guarantees, corporate bond issuance had to shift to a mostly non-guaranteed basis. Whereas in the fourth quarter of 1997 guaranteed bond issuance accounted for over 90% of total issuance, by the fourth quarter of 2001 the share had sunk to less than 1% (Table 2). Initially, only companies with the highest ratings retained access to the bond market. Gradually, however, companies of intermediate credit quality were also able to issue bonds. In contrast to the period before 1997, spreads on these bonds reflected more accurately the creditworthiness of the issuers.

... highlight the difficulty of graduating from guarantees

Securitisation played a key role in the transition to this new stage in the development of the Korean bond market. During the same period, as the issuance of corporate straight bonds decreased, the issuance of ABSs increased significantly (Table 2). In large part, this was because public credit guarantees continued to be widely available in the ABS market, as discussed above. Therefore, even though the Korean corporate bond market was transformed to mostly non-guaranteed bonds, active provision of credit guarantees by the government – largely for structured securities – continued at least for a few years after the 1997 crisis.

Development of the Korean corporate bond and ABS[1] market, 1997–2001

In trillions of won

	1997	1998	1999	2000	2001
Issuance					
Corporate straight bonds	34.3	56.0	26.3	17.7	40.1
ABSs	0	0	4.4	41.0	39.6
Total	34.3	56.0	30.7	58.7	79.7
Amounts outstanding[2]					
Corporate straight bonds	90.1	122.7	115.2	89.9	83.0[3]
ABSs	0	0	4.4	43.7	65.1[3]
Total	90.1	122.7	119.6	133.6	148.1[3]
Share of issuance of corporate straight bonds with guarantees[4]	92.6	2.8	8.1	1.5	0.9

[1] ABSs include primary CBOs, secondary CBOs, CLOs, credit card ABSs, lease ABSs and NPL ABSs. [2] Year-end. [3] End-November 2001. [4] Share of total issuance of corporate straight bonds in the fourth quarter of each year, in per cent.

Source: Bank of Korea (2002). Table 2

In sum, the shift from bond guarantees by banks and credit guarantee companies to government guarantees on ABS transactions between 1997 and 2001 in Korea shows how difficult it can be for financial markets to reduce their dependence on credit guarantees.[12] The government had to provide temporary credit guarantees in many forms until the financial markets became more settled. This experience also underscores the importance of complementing government policies with the promotion of financial market infrastructure, such as credit rating systems and accounting standards.

Even with securitised structures, governments need to be cautious in providing credit enhancements. A tranching structure can mitigate moral hazard problems, since the interests of the sponsor can then be aligned with those of the CBO investors (IAIS (2003)). However, since the purchase of equity tranches by guarantee institutions can diminish the beneficial effects of the incentives of tranching structures, additional devices to restore the right incentives for banks and borrowing firms may be needed.[13] Furthermore, when banks originate new loans with eventual securitisation in mind, these loans may be screened and monitored less carefully. The problem might become more severe if banks know that a guarantee institution will hold the equity tranche.

Conclusion

In many Asian countries, government institutions have played an important role in providing credit guarantees for corporate debt. This has been accomplished either through direct guarantees of loans and bonds, or through credit enhancements to ABS transactions. In China, by contrast, private companies are the principal providers of corporate credit guarantees. The cross-country evidence suggests that credit guarantee institutions that are highly leveraged, provide close to complete guarantees for loans, or offer a large amount of credit guarantees relative to GDP, tend to exhibit poor underwriting performance and profitability. The historical performance of credit guarantee systems highlights the importance of guarantors having sufficient capitalisation and prudent risk management practices. At the same time, it underscores the difficulty for the financial market in moving away from credit guarantees.

[12] Moreover, the investors in Korean credit card ABSs were protected indirectly by the Korean government during the credit card crisis. This also confirms the difficulty of weaning the bond market away from credit guarantees (Moreno (2006)).

[13] Recent CBO issuance in Korea sheds some light on how this might be done (Small and Medium Business Administration (2005)). In one case, borrowing firms were required to purchase a mezzanine tranche to increase their stake in the securitised credit. In another fund, the mandatory purchase of a mezzanine tranche varied between 0 and 8% depending on the credit rating of the firm. This second device was intended to discourage very risky credits from joining the borrowing pool as free riders.

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