Does Informal Finance Help Formal Finance Evidence from Third-Party Loan Guarantees in China

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Discussion outline

- **Main findings**

- **Big picture (substantive) issues**

- **Some empirical issues**

- **Concluding remarks**

Main findings

- **The paper studies third-party loan guarantees in facilitating bank ending to SMEs in China.**

- **The paper's main findings are:**

  - Banks and guarantors disagree on loan credit risk. Bank loan rates predict default, but guarantor credit measures do not.

  - In a related manner, high collateralization is negatively associated with guarantor credit risk but positively with bank loan rate (and default probability).

  - Very puzzling, since the banks and guarantors work together.

Big picture issues

- The paper claims that the guarantor's role is economically inefficient. Guarantor behavior is consistent with the "lazy lender" model Manove *et al* (2001).

- The paper also claims that credit guarantee represents "informal finance".

- Hence the paper concludes that informal finance is economically ineffective.

- Both claims, and the conclusion, are debatable.

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- **If the credit guarantee schemes bring the effective interest rate for the borrower (officially regulated rate + guarantee premium) to the market rate, then the CG helps the financial intermediation system become more efficient and complete.**

- **"Regulatory arbitrage" is inevitable in a regulated market, often with good consequences.**

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- In Manove et al (2001) model, a bank may become lazy in monitoring a borrower if the collateral provided is sufficient to cover any losses.

- The credit guarantee firm in the paper is contractually obligated to make up for as much as 90% of loan default loss. The banks have a virtually risk-free loan and may perhaps become lazy.

- Since almost the entire burden of covering loan loss is on the guarantor, how do we conclude that the guarantor is lazy? Doesn't it do the monitoring job that the banks would do in the case of a unguaranteed loan?

Big picture issues:
formal versus informal finance

- **The existing literature includes four papers:**

  1. **Allen, Qian, and Qian (AQQ), "Law, Finance, and Economic Growth in China, JFE, 2005**

  2. **Ayyagari, Demirguc-Kunt, and Maksimovic (ADM), "Formal versus Informal Finance: Evidence from China", RFS, 2010**

  3. **Allen, Chakrabarti, De, Qian, and Qian (ACDQQ), "Financing Firms in India", 2011.**

  4. **De and Singh, "Credit Rationing in Informal Markets: The Case of Small Firms in India", 2011.**

- **While papers 1 and 3 suggest a meaningful role of informal finance in economic growth of China and India respectively, paper 2 documents a big role of formal finance in China.**

- **Paper 4 finds evidence of rationing of informal credit in India.**

- What is informal finance (Dixit, 2001)?

- How is it different from "alternative" finance? "Non-market" finance?

- Where does the present paper fit in this literature?

- Actually nowhere. Credit guarantee firms in China in the present sample do not provide any finance themselves.

- They support provision of formal finance. They provide auxiliary services to banks.

- Their relationship with banks are contractual.

- CG firms perform an economically useful function. They help effective rates rise to market-clearing rates and bring in borrowers who are rationed out of the market.

- Marginal borrowers are very susceptible to moral hazard problems. Pledging of collaterals are important in mitigating this problem (Bernanke and Gertler, 1989; Kiyotaki and Moore, 1997; Banerjee and Newman, 1993; Liberti and Mian , 2010, De and Singh, 2011).

- Hence, CG risk measure is negatively associated with size of collaterals, as the paper finds.

- Guaranteed loans are virtually risk-free for banks. Data reflects that. The observed number of defaults are too few: 15 out of 1,052 observations (1.4%)?

- No reason why CG risk measure should influence bank loan rate. Perhaps CG assets would be a more appropriate variable to look at.

■ The alternative interpretation needs to answer several questions.

■ Why do the CG firms take all the downside risk? Answer: they are appropriately rewarded. CG premium is 40% of loan rate on average (table 1)

■ If loans are virtually risk-free for the banks, why do loan rates predict defaults (results in tables V and IX)?

■ But, how can we be sure of the results when the observed number of defaults are too few?

■ Besides, there are other econometric issues.

Empirical issues: data

- **Very interesting data.**

- **But, data seems unauthenticated. How to verify the data?**

- **In 2009, 40% of CG firms were illegal (p. 11 of text).**

Empirical issues: tests

- Tests should have been conducted with the sample of loans by banks in table 1: 772 observations.

- Bank fixed effects should be used. From table 1B, 15 different banks extended the sample loans.

- In tests of consistency of loan rates with CG risk measures, both the risk measure and the borrower characteristics are regressors. Since the characteristics determine the risk measure, evidence of multicollinearity problems.

- Loan defaults are regressed on loan rates in two separate tests (tables V and IX). The tests should be combined to avoid several problems, including endogeneity.

A few editorial issues

- Is the model adding much?

- Some important information are in footnotes (ex. footnotes 3 and 5)

Concluding remarks

- Interesting project for several reasons.

- Interesting data, but needs to be authenticated.

- The tests need to be thought through again. Some tests perhaps need to be done again.

- The findings need to be positioned differently.

Thank You