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Differentiating the Guaranteed Rate: A Way to Improve the Sunshine Loan Program

Yoonhae Oh, Fellow at KDI

“The uniformly high guaranteed rate currently provided by ‘Sunshine Loan’ through non-bank depository institutions does not incentivize the financial institutions to put enough efforts into the preliminary screening or follow-up management. If the policymakers are to enhance the capacity of non-bank depository institutions in dealing with subprime unsecured personal loans (microcredit), they should differentiate the guaranteed rate according to the credit rating, the loan amount, and the number of loan issued to the same person.”

I. Introduction

The Sunshine Loan, which was introduced in 2010, is a subprime unsecured personal loan (microcredit) by non-bank depository institutions. Once financial institutions issue Sunshine Loans to the individuals with low income or bad credit, the Korean Credit Guarantee Foundation partially guarantees loans.

* This is the translated version of *KDI FOCUS* released on June 18, 2014.

* This paper expands upon Chapter 5 of Yoonhae Oh, *Microcredit Products for Low-Income and Low-Credit people in Korea: Focusing on the Political Products Driven by Financial Inclusion Policy*, Policy Research Series, August 2013, Korea Development Institute, 2013.

The positive effect of Sunshine Loan is that it eased financial exclusion of those who in the past were typically forced to use private money lenders that charged very high interest rates. Moreover, it was expected that the experience with issuing loans to these borrowers would improve the capacity of the financial institutions through accumulated data.

However, the weaknesses of the Sunshine Loan program are gradually coming to light. High credit default rate is deteriorating the soundness of financial institutions. Market forces are still not creating an adequate supply of lower interest-rate subprime unsecured personal loans, and non-bank depository institutions have failed to demonstrate a capacity for preliminary screening or follow-up management in issuing Sunshine Loans. In addition, concerns have also been raised that if the market comes to depend on such political products by government, it could delay the development of an independent microcredit market.

Sunshine Loan is a temporary program that will continue to run until the special guarantee funds¹⁾ are depleted entirely. If no changes are made in the current operation of Sunshine Loan distribution, there will be no improvements in the market even after the program is finished. As a result, improving the program is of vital importance so as to minimize its negative impacts and to maximize the benefits. With the goal of offering potential ways to improve the program, this paper will analyze non-bank depository institutions' handling of Sunshine Loan and borrowers' delinquent behavior.

Since Sunshine Loan is a partially-guaranteed program, it is particularly important to set the guaranteed rate at an appropriate level. Unfortunately, there is the following dilemma: if the guaranteed rate is too low, financial institutions will avoid issuing Sunshine Loans, which could reduce the effectiveness of the program. On the other hand, with high guaranteed rate, financial institutions may put less effort into preliminary screening and follow-up management. This point is illustrated in the history of changing the guaranteed rate of Sunshine Loans. Initially, the guaranteed rate was 85 percent, but it was adjusted to 95 percent after too few loans were issued by financial institutions. Later, when a high accident rate was observed, the guaranteed rate was altered once more, to 90 percent in the case of livelihood loans for workers. These adjustments reflect the difficulty of finding an appropriate level of guaranteed rate. This paper seeks to explain why the guaranteed rate should be differentiated in order to motivate the financial institutions to use relationship banking and to put more effort into follow-up management.

The application of differentiated guaranteed rates is required to motivate non-bank depository institutions to use relationship banking and to step up their efforts in follow-up management.

1) The guaranteed fund for Sunshine Loan contains KRW 2 trillion, and when it was initiated the goal was to operate the fund until 2015. However, since fewer loans have been issued than original expectation, the fund contains surplus money, and it is very likely that its period of operation is likely to be extended.

II . Necessity of Improvement in Sunshine Loan Operation

1. Comparison of Sunshine Loan with Other Political Microfinance Products

Though there are multiple understandings on the term, microcredit broadly refers to the provision of unsecured personal loans to individuals with low income and bad credit. The cooperative banking such as credit union and saving bank is frequently used by such individuals. Since the 1997 Asian Financial Crisis, secured loans have gradually come to represent a greater share of the loans issued by these financial institutions.²⁾ Consequently, the percentage of the unsecured personal loans they issue, and their ability to issue such loans, have slowly decreased. Thus, there is a shortage of standard financial products that are available to people with low income or bad credit rating. After experiencing the global financial crisis, the Korean government introduced some political microcredit products such as Sunshine Loan, to manage the increasing concern on financial exclusion.

<Table 1> compares the characteristics of the three representative political microcredit products in Korea; Smile Microcredit, Sunshine Loan, and New Hope Loan. Smile Microcredit Bank is a non-profit organization which is funded by dormant deposits and donations. It provides microcredit to small business owners, and arranges supplementary services such as management training for self-support. Another political microcredit product is New Hope Loan, which is run by commercial banks with their own fund. However, New Hope Loan is criticized to be inefficient as the operating cost at banks is very high for providing microfinance. Concerns have also been raised that banks are poaching the most reliable customers of the non-bank depository institutions, a practice that could hinder the development of microcredit market. Due to the direct connection between Sunshine Loan and non-bank depository institutions that generally control the supply of microcredit, Sunshine Loan is believed to play the most crucial role among the three products.

Comparing the default rate for these programs, it appears that the guarantee credit default rate of Sunshine Loan is 13.5 percent, much higher than the 6.8 percent of Smile Microcredit and the 3 percent of New Hope Loan. Considering that the application requirements for Sunshine Loan fall between those of Smile Microcredit and New Hope Loan, the guarantee credit default rate of Sunshine Loan is surprisingly high, even taking into account the credit risk of average borrower. Such high guarantee credit default rate indicates the necessity to improve the manner in which the non-bank depository institutions handle Sunshine Loans.

The guarantee credit default rate of Sunshine Loan is 13.5 percent while the default rate of Smile Microcredit is 6.8 percent, and the default rate of New Hope Loan is 3 percent.

2) The percentage of unsecured loans at non-bank depository institutions was 25 percent in 2003, but it has gradually declined, reaching 11.3 percent in 2011 (Sang-ho Son and Jae-yeon Lee [2013], p. 18).

<Table 1> Comparison of Three Political Microfinance Products

	Smile Microcredit	Sunshine Loan	New Hope Loan
Default rate	6.8% (end of April 2013)	Guarantee credit default rate: 13.5% (end of May 2013, subrogation rate: 9.7%)	3.0% (end of April 2013, default rate after 2% amortization)
Funding	Dormant deposit accounts and donations	Funding guaranteed through contributions from non-bank depository institutions (KRW 1 trillion) and the government (KRW 1 trillion)	Banks' own funding
Amount of support	KRW 634.4 billion (48,852 people) (January 2010–April 2013)	KRW 3 trillion (336,000 people) (July 2010–April 2013)	KRW 4.3 trillion (475,000 people) (November 2010–April 2013)
Support qualification	(1) People with bad credit rating (7-10) (2) The poor, those eligible for basic living allowance and earned income tax credit	(1) Those making KRW 40 million or less a year with bad credit rating (6-10) (2) Those making KRW 26 million or less a year	(1) Those making KRW 40 million or less a year with bad credit rating (5-10) (2) Those making KRW 30 million or less a year

Note: The application requirements for Sunshine Loan and New Hope Loan from 2014 were combined as follows: (1) those making KRW 40 million a year or less with a credit rating between 6 and 10 (2) those making KRW 30 million a year or less.

2. Handling of Sunshine Loans by Non-bank Depository Institutions

A user sample was used to analyze how non-bank depository institutions handle Sunshine Loans. The analysis shows that for the most part, the financial institutions issued borrowers a loan with a large amount that was close to the guarantee limit.³⁾ The data in <Table 2-1> shows the distribution of the number of times that financial institutions issued Sunshine Loans to each borrower. According to <Table 2-1>, 83.7 percent of borrowers in the total sample were issued loans only one time. The percentage of borrowers who were issued loans once was the highest (88.9 percent) at savings banks, and the percentage of these borrowers who were issued multiple loans,⁴⁾ which is to say several loans being issued at the same time, was 55.7 percent. <Table 2-2> shows the average loan amount by the number of loan issued to the same person. According to <Table 2-2>, it becomes apparent that the average amount for multiple loans is unusually high, around KRW 18 million.

The current practice of lending a large amount of money to borrowers all at once even before collecting detailed information about them fails to adequately respond to the continuing demand for loans from low-income earners. It is also very dangerous since it increases the amount of money lost when a credit default occurs. Sunshine Loans can be divided into three categories: refinance loans (which convert a high-interest rate loan to

Currently, non-bank financial institutions lend a large amount of money to the borrower at once before collecting detailed information about the borrower.

3) The maximum of the operating loan is KRW 20 million for a business owner, KRW 10 million for livelihood loans for workers, and KRW 30 million for refinance loans. The guarantee limit is determined by the guarantee foundation after assessing the credit risk of the borrower.

4) The term "multiple loans" here refers to borrowers who were issued a refinancing loan and a livelihood loan together, or a refinancing loan and a business operating loan at the same time. When several loans are given to the same borrower within the period of one week, this is also categorized as a multiple loan.

<Table 2-1> Distribution of Number of Loan Issued to the Same Person at Non-bank Depository Institutions Handling Sunshine Loans

(Unit: %)

Number of loan issue	Total	Saving Bank	Cooperative Federations	Credit Union	Community Credit Cooperatives
1 time	83.7	88.9	85.9	81.0	79.1
Multiple loan	(10.9)	(55.7)	(0.8)	(1.5)	(1.2)
2 times	13.8	10.4	12.2	15.7	17.2
Multiple loan	(7.0)	(51.0)	(0.4)	(0.9)	(0.6)
3 or more times	2.4	0.8	1.9	3.3	3.8

Note: Loans that were issued from July 2010 to May 2013. Multiple loans refer to instances where borrowers receive several loans within one week. The figure in parentheses is multiple loans as a percentage of the loans issued the first and the second time. Cooperative Federations include agricultural, fisheries and forestry cooperative federation. Business operating loans in Gyeonggi Province, Seoul, and Ulsan were excluded, as were funds for holidays and starting new businesses. Data that did not provide information about the date of issuance or the amount were also excluded.

Source: Calculated by the author using raw data provided by the Korea Federation of Credit Guarantee Foundations.

<Table 2-2> The Average Loan Amount by the Number of Loan Issued to the Same Person in Sunshine Loan

(Unit: KRW 10,000)

Number of loan issue	Total	Business owner	Worker
1 time	847.2	1,064.8	782.7
Multiple loan	1,735.8	1,822.7	1,733.4
2 times	873.1	973.6	793.9
Multiple loan	1,762.2	1,882.8	1,757.1
3 or more times	877.8	934.1	819.3

Note: Loans that were issued from July 2010 to May 2013. Multiple loans refer to instances where borrowers receive several loans within one week. Businesses operating loans in Gyeonggi Province, Seoul, and Ulsan were excluded, as were funds for holidays and starting new businesses. Data that did not provide information about the date of issuance or the amount were also excluded.

Source: Calculated by the author with raw data provided by the Korean Federation of Credit Guarantee Foundations.

a low-interest rate loan), livelihood loans for workers, and operating loans for business owners. As it was very rare for the program to issue loans for starting a new business, there was little reason for the financial institutions to lend borrowers large amounts of money at once.

III. Necessity of Using Relationship Banking and Strengthening Delinquency Management

Just as in Korea, small business owners and low-income earners in Germany and the United States find that their economic standing hinders them from receiving unsecured personal loans from commercial banks. However, in these countries, financial cooperatives, savings banks, and regional banks provide them with financial services in a way that can be described as relationship banking. Relationship banking is defined as issuing loans based on customer specific non-financial information acquired through multiple interaction with the same customer over time or/and across products (Boot [2000], pp. 9–12). This

The default occurrence rate is calculated based on the number of loans. It should be noted that this is different from the general default rate, which is based on the amount of the loan.

<Table 3> Comparison of Default Occurrence Rate by Credit Rating for Sunshine Loan and Smile Microcredit

(Unit: %)

Credit rating	Sunshine Loan credit default rate		The rate of being in arrear more than twice for borrowers of Smile Microcredit (using relationship banking)	The difference in default occurrence rate for Sunshine Loan and Smile Microcredit	
	Business owner	Worker		Business owner	Worker
Credit ratings 1-4 (good)	11.3	7.8	1.7	9.6***	6.1***
Credit ratings 5-6	24	16.6	4.4	19.6***	12.2***
Credit ratings 7	31.9	24.5	13.5	18.4***	11.0***
Credit ratings 8-10 (poor)	43.8	34.1	19.5	24.3***	14.6***

Note: The credit default occurrence rate is the number of defaulted (being in arrear more than twice) loans divided by the total number of loans. As such, it is different from the default rate, which is based on the amount of the loan. Sunshine Loan credit defaults refer to cases when the borrower is in default for one month or more, which corresponds to when the borrowers of Smile Microcredit Bank are in arrear more than twice.

*** shows that it is statistically different from zero at the 1% significance level.

Source: Calculated by the author using raw data from the Smile Microcredit Bank and the Korea Federation of Credit Guarantee Foundations.

practice tends to involve active follow-up management and screening. Relationship banking is believed to be effective at determining repayment ability for lenders, where there is substantial information asymmetry. In Korea as well, a growing body of research is suggesting that non-bank depository institutions should use relationship banking (Sohn and Lee [2013]).

At this point, a comparative analysis of the delinquent behavior of Sunshine Loan and Smile Microcredit users was carried out according to credit rating. The object of this analysis was to demonstrate that non-bank depository institutions dealing with Sunshine Loan need to use relationship banking and improve their follow-up management.⁵⁾ The default occurrence rate used in this analysis was calculated with the number of loans, and as such it is different from the general default rate which is based on the amount of the loan.⁶⁾

1. Usefulness of Relationship Banking in Screening for the Subprime Unsecured Personal Loans

The results of the analysis in <Table 3> suggest that if non-bank depository institutions that issue Sunshine Loans used relationship banking with borrowers with bad credit ratings, they would be able to lower the risk of credit default occurrence. Smile Microcredit is closer in nature to relationship banking than Sunshine Loan,⁷⁾ and it also shows a lower

The default occurrence rate for borrowers with bad credit ratings is markedly lower for Smile Microcredit than for Sunshine Loan.

5) Loans issued from October 2010 to February 2012 were included in the sample. The special loans for major holidays and business operating loans in the Ulsan area were excluded from Sunshine Loan sample. The records of guarantee credit default and subrogation in the Sunshine Loan program were calculated at the end of May 2013, and the frequency of being in arrear for Smile Microcredit were calculated at the end of June 2013. Sunshine Loans issued for refinancing and Smile Microcredit issued in connection with cars (which are secured loans) were excluded from the sample.

6) Since the default occurrence rate takes into account all past records of default, it will likely to be higher than the general default rate.

default occurrence rate. For preliminary screening in Sunshine Loan, the guarantee foundation relies on a standardized procedure to determine whether the applicant is qualified to receive the loan. During the preliminary screening for Smile Microcredit Bank, on the other hand, the bank makes use of the qualitative customer-specific information acquired over a long period of time, visiting the workplace, providing the applicant with management training, and offering consulting.

The default occurrence rate in Smile Microcredit is significantly lower than Sunshine Loan for the bad credit ratings of 8–10.⁸⁾ These results indicate that relationship banking is more effective at determining credit risk of borrowers with bad credit, individuals with a high credit risk and information asymmetry. Therefore, non-bank depository institutions ought to be encouraged to use relationship banking when dealing with Sunshine Loan.

2. Necessity of Strengthening Delinquency Management in Sunshine Loan

Upon closer examination, a comparison of the long-term default conversion rates for Smile Microcredit and Sunshine Loan implies that strengthening follow-up management could have the result of reducing long-term default. In <Table 4>, which expresses the rate at which defaulted loans are converted to long-term default, the subrogation conversion rate for Sunshine Loan is higher than the long-term default conversion rate of Smile Microcredit. This can be interpreted as a result from the disparity in the effort on the follow-up delinquency management, which is caused by the two programs' different risk-sharing scheme. Since Smile Microcredit Banks take 100 percent of the credit risk upon themselves, they are committed to follow-up management. The branch staffs meet frequently with borrowers and encourage them to keep up with their repayment schedule. With Sunshine Loan, by contrast, if default continues for an average of three or more months after the first default is recorded the guarantee foundation provides 95 percent⁹⁾ of the outstanding loan to the financial institution. As a result, non-bank financial institutions have no incentive to dedicate energy to follow-up management, which would incur high costs. Thus, in order to motivate financial institutions to put more effort on delinquency management, the guaranteed rate must be lowered.

When comparing differences between the long-term default conversion rates of the two programs in <Table 4>, the data regarding good credit ratings of 1–4 makes this variance

The long-term default conversion rate for borrowers with good credit ratings is markedly lower for Smile Microcredit than for Sunshine Loan.

7) There are other differences between Smile Microcredit and Sunshine Loan. The record of defaults for Smile Microcredit is not provided to credit rating agencies; recipients of Smile Microcredit have lower incomes than recipients of Sunshine Loans; and the interest rate for Smile Microcredit is 1–4.5%, lower than the 8–10% interest rate of Sunshine Loans.

8) Considering that there is one-year grace period for business operating loans in the case of Sunshine Loans, the actual difference in default occurrence rate between the two programs could be greater.

9) Since the guaranteed rate before August 2012 was 85 percent, a guaranteed rate of 85 percent was applied in most of the sample used in this analysis.

<Table 4> Comparison of Long-term Default (Subrogation) Conversion Rate by Credit Rating for Sunshine Loan and Smile Microcredit

(Unit: %)

Credit rating	Category	Sunshine Loan subrogation conversion rate		Smile Microcredit long-term default conversion rate (extensive follow-up management)	Difference in long-term default conversion rate for Sunshine Loan and Smile Microcredit	
		Business owner	Worker		Business owner	Worker
Credit ratings 1–4 (good)		71.3	81.4	47.0	24.3***	34.4***
Credit ratings 5–6		75.6	86.8	56.6	19.0***	30.2***
Credit ratings 7		76.9	86.0	71.7	5.2***	14.3***
Credit ratings 8–10 (poor)		81.0	87.2	78.3	2.7***	8.9***

Note: Long-term default (subrogation) conversion rate = instances of five or more defaults / instances of two or more defaults (instances of subrogation / instances of default occurrence).
Subrogation of Sunshine Loans refers to cases in which default occurs an average of three times after the occurrence of an accident, which corresponds to defaults occurring five or more times.

*** shows that it is statistically different from zero at the 1% significance level.

Source: Calculated by the author using raw data from the Smile Microcredit Bank and the Korea Federation of Credit Guarantee Foundations.

even more pronounced.¹⁰⁾ In this regard, lowering the guaranteed rate for the people with good credit ratings would be an effective way to motivate non-bank depository institutions to prioritize delinquency management. In addition, given that the default occurrence rate for borrowers with good credit ratings is much lower than for those with bad credit ratings as in <Table 3>, keeping high guaranteed rates for the people with good credit ratings appears even less useful.

IV. Policy Suggestion: Differentiation of the Guaranteed Rate

Previously, this paper mentioned that non-bank depository institutions issuing Sunshine Loan would greatly benefit from using relationship banking. The method proposed for bringing this about is a stepwise approach to issuing loans. This involves lending borrowers a small amount of money at first, then lending them a large amount of money after forming a relationship and compiling information about their credit risk. Non-profit microfinance institutions such as ADIE in France and ACCION in the United States also employ such approach as a way to mitigate information asymmetry. This method not only enables financial institutions to collect qualitative customer-specific information, but also functions as a dynamic incentive for borrowers to work harder to repay their loans so that they could receive additional loans. Also, with this approach, the financial loss of non-bank institutions would be less severe as the amount of defaulted initial loan is small.

However, given the expenses associated with dividing up loan process and collecting information about borrowers, financial institutions have little incentive to use stepwise

10) Considering the fact that the income level that is used for high credit ratings is considerably lower in Smile Microcredit (KRW 40 million or less in yearly income for Sunshine Loan, much less for Smile Microcredit), the difference in the long-term default conversion rate between the two programs becomes even more significant.

The stepwise loan method involves loaning a small amount of money to gain information about the borrowers before lending them larger amount of money.

<Table 5> Sample Method of Differentiating the Guaranteed Rate

Times borrower has received loans	Amount	Bad credit rating		Good credit rating	
		Less than KRW 3 million	KRW 3 million or more	Less than KRW 3 million	KRW 3 million or more
The first time		95%	85%	90%	80%
The second time or more		90%		85%	

approach. The guarantee foundations that cover the majority of the credit risk would enjoy the most benefits from relationship banking, but the foundations are unable to implement relationship banking and collect customer-specific information about borrowers themselves. Consequently, it is necessary for the guarantee foundations to differentiate the guaranteed rate according to credit rating, the amount of the loan and the number of loan issued to the same borrower, thus inducing the financial institutions to adopt the stepwise approach when they issue Sunshine Loans.¹¹⁾

<Table 5> which provides a sample method of differentiating guaranteed rates, applies the lowest guaranteed rate to borrowers who are given a large amount (KRW 3 million or more, for example) the first time they are issued a loan.¹²⁾ However, the highest guaranteed rate (95 percent) is applied when borrowers are given a small amount for their first loan in the interest of encouraging the formation of a relationship. After non-bank depository institutions submit a record showing that the first loan was repaid on time, a guaranteed rate at an intermediate level (90 percent) will be authorized starting with the second loan. Differentiating the guaranteed rate in this manner can be used as an incentive, encouraging the financial institutions to establish relationships with borrowers by giving them a small amount for the first loan and moving on to larger amounts beginning with the second loan.

In addition, this paper also mentioned the necessity of lowering the guaranteed rate in order to induce non-bank depository institutions to put more effort into effective delinquency management. However, there is also a concern that lowering the guaranteed rate could prevent the financial institutions from issuing Sunshine Loans. Considering such possibility, it is recommended to lower the guaranteed rate for borrowers with good credit ratings, for whom there is lower risk of credit default. As has already been noted, if follow-up management is increased for borrowers with good credit ratings, the chances of long-term default conversion are very low. Therefore, as seen in <Table 5>, setting a low guaranteed rate for borrowers with good credit ratings will provide the financial

The guaranteed rate must be differentiated according to the credit rating, the amount of loans and the number of loan issued to the same person in order to induce financial institutions to use the stepwise loan method.

A low guaranteed rate should be applied to borrowers with good credit ratings to encourage financial institutions to put more effort into effective delinquency management.

11) The supply of loans is greatly affected by changes in the guaranteed rate. When the Sunshine Loan guaranteed rate was adjusted from 85 percent to 95 percent, for example, the daily average amount of loans jumped from KRW 1.5 billion (January–August) to KRW 3.8 billion (August–December).

12) This accounts for the fact that KRW 4 million is the maximum loan amount for borrowers with credit rating of 10

institutions with an effective incentive to put more effort into follow-up management when borrowers go into default.

V . Conclusion

This paper proposes the differentiation of the guaranteed rate as a way to incentivize non-bank depository institutions to use relationship banking and to prioritize follow-up management. As Sunshine Loan is not a welfare subsidy, it must be operated according to market principles. In addition, while Sunshine Loan is a short-term program that was introduced to make up for the market failure, it should be run in such a way that could contribute to the recovery of the microcredit market in the long run. In order to achieve this, financial institutions need to expand their embrace of relationship banking so that they could gain more experience in assessing the ability of low-income earners to repay loans and in managing the repayment process. However, in the current structure, Sunshine Loans receive a uniformly high guaranteed rate, which does not encourage the financial institutions to develop their capacity for providing microcredit. Therefore, guaranteed rates must be differentiated according to the number of loan issued to the same borrower and the amount of the loans as a way to give non-bank depository institutions the incentive to adopt a stepwise approach to issuing loans.

It is crucial to seek methods for motivating non-bank depository institutions to expand local, relationship-based banking and to be faithful to their original function.

In addition, the guaranteed rate for the people with good credit ratings must be lowered to motivate non-bank depository institutions to make an effort to engage in effective follow-up management.

Furthermore, the financial authority needs to approach with the long-term objective of bringing about the recovery of the microcredit market. The past method of relying upon the loan guarantees needs to be replaced with plans for enhancing the ability of the financial institutions to provide microcredit. There is an urgent need to find ways to motivate non-bank depository institutions to expand relationship banking. Some possible ways include providing incentives or technical support. ■

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