

Payment holidays can ensure liquidity and credit survival

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CREDITWORTHINESS is very difficult to build, but it is very easily ruined. This is because the critical factors in building up creditworthiness are time-proven and interactive processes, such as payment record and accountability.

In everyday life, one experiences events like marriage, death or natural disasters. These events may interrupt the ability to honour one's debt obligation. General insurance and social welfare as risk sharing mechanisms are offered to ease these contingency difficulties.

During this global financial crisis, tough times and economic hardship lie ahead for everyone, with potential sales crises and losses of jobs. The government is the risk-sharing agent of last recourse and has a role to solve the issue as private institutions are extremely risk averse and cannot take any more chances.

Tax cuts, temporary suspension of social security contributions and freebie handouts are among the good features of the current fiscal stimulus package for needy people during the recession. They aim to provide extra cash liquidity for lower income people, allowing them to spend and to expand the economy through multiplier effects. Working on a cash-based stimulus may be necessary, but it is not sufficient to jump-start our credit-based society in Thailand.

With a cash-based spur, the multiplier benefit will be at most a two-baht effect for every one baht spent. Working with credit the multiplier effect can be at least 10 times that of spending. Thus, the top priority should be to preserve our credit system for "more bang for the baht".

Taking credit-card borrowers as an example, most credit card holders are salaried workers and small- and medium-sized business entrepreneurs. They are typically middle class people and are the bedrock of the new Thai economy. Despite their education and work ethic, along with their good tax and debt payment record, they are still subject to exogenous economic shocks. Involuntary unemployment may force them to default on their debt

obligations because cash preservation is equivalent to family security. To adjust to a new reality through new training and new jobs will take time and resources. The government may provide free training and more hand-outs, but what about credit commitment? One simple way to improve the lot of credit-constrained workers is a "payment holiday" plan to defer minimum monthly payments and to waive high interest penalties on special circumstances.

The key to the success of the "payment holiday" option is in its design and execution. In the short run, we should encourage more people to keep up their good credit scores. In the medium to long term, we should work to preserve our credit extension system.

Keeping non-performing loans off the books of banks and financial institutions should be a main objective. An incentive compatibility mechanism is required. First, this plan should be available only for any account that is not past its due date or is over the credit limit.

It should be stressed that this is not a debt reduction plan. The primary aim is to protect card-holders' creditworthiness by providing more time - let's say 6 to 12 months - so they can adjust to a new economic lifestyle. The plan would only be activated at least one month after card-holders subscribed to it. Imposing this clause would extend their responsibility and commitment. It is also good for risk and reward pooling. The pricing of the plan should be on a risk-based premium. Fees should be calculated on the outstanding balance of the account with a sliding scale premium depending on payment history.

The plan should be sold and managed by private financial institutions. Tapping productive franchises, adding extra fee income, collecting more valuable customer data and improving balance sheets are among the reasons for the government to adopt the scheme.

The most fascinating part about this plan is its low cost. The government is only responsible for interest on the interest payment during the deferral period. With the highest credit rating assurance, the government can also negotiate for much lower interest pay-outs than collective card-holders.

From a back-of-an-envelope calculation, for every baht the government spent on this plan Bt100 could be saved in credit or reduced NPLs. Theoretically, the government may utilise as little as Bt2.6 billion to save the credit card system an outstanding Bt260 billion approximately. This Bt2.6 billion is much less than the amount spent on freebies. Moreover if the plan is executed well as a throughput insurance policy scheme, the government may need little or no cash endowment and even make some profit at the end.

It is imperative to understand the mathematic concept of the stated risk-sharing scheme before rushing out and extending the above idea to other types of loans. The credit card loan is a good example because its default probability is largely dependent on the "Law of Large" numbers. As more people participate in the plan, the more predictable the default probability

conjecture to be highly correlated with general economic conditions. This is crucial to risk management because it provides guides for proper premium pricing and loss reservation.

Other types of loans such as housing and corporate loans may require more thought because of their idiosyncratic risks and principal-agency problems. This can be done, but it requires more careful consideration.

In conclusion, I salute the current government in trying to stimulate our economy in the midst of the global financial and economic crisis. To prevent a severe economic contraction and to avoid a depression, we need to ensure not just liquidity, but also credit extension. The government, as the risk-sharing agent of last recourse, has to preserve our credit system through innovative intervention.

The example of the "payment holiday" plan is discussed and presented above as a simple idea on how to leverage government spending to save our creditworthiness and economy.

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