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A CREDIT GUARANTEE FACILITY TO ENHANCE BANKABLE CUSTOMARY LAND LEASES IN PAPUA NEW GUINEA

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Key Points

- A credit guarantee facility is a funding arrangement by government or an entity, which serves as security for loans, encouraging lending by banks.
- Such a facility could be considered as an option by Papua New Guinea (PNG) to make customary land bankable by giving comfort to banks to extend credit on customary land.
- PNG stands to benefit from the facility by encouraging banks to lend and private sector to invest, improving the livelihoods of landowners, mobilising customary land for development, and increasing government revenue.
- For the proposed facility to be successful, effective guidelines for access and repayment must be established and the facility must be designed to be self-sustaining.
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A CREDIT GUARANTEE FACILITY TO ENHANCE BANKABLE CUSTOMARY LAND LEASES IN PAPUA NEW GUINEA

By Logea Nao

At present, banks are hesitant to accept customary land leases as security to extend credit for development due to risks. A customary land lease is a legal document that allows the leaseholder to use the land for the duration of the lease (Nao, 2021a). The lease is derived from a customary land title that is obtained by registering customary land, a title that recognises ownership of customary land. The same principle applied in the creation of State title and State lease over land under the ownership and control of the State is applied here, but in the context of customary land. Under the current laws, the customary land title is a parent freehold which is issued to an Incorporated Land Group (ILG), a social unit that claims rights to the land that is being considered for titling. The incorporation of the land group is a process that precedes the registration of customary land (Nao, 2021b). In 2022, the National Research Institute (NRI) conducted a study to identify and examine factors that are contributing to risky customary land leases in PNG, and to identify a potential strategy for providing secure and bankable customary land leases in PNG. Consultations were held in Alotau, Mt Hagen, Kokopo and Lae with commercial banks, provincial administrations, targeted ILGs with registered customary land leases, and developers with investments on customary land. Key findings of the study include bank employees are not fully aware of the customary land title and lease derivation process; the government consider two options to facilitate funding – establish a National Customary Land Bank and/or establish a credit guarantee facility similar to the small and medium-sized enterprise (SME) facility; and, the government to consider establishing a separate entity to administer customary land (Nao et al., forthcoming). This paper focuses on the establishment of a credit guarantee facility for customary land.

What is a credit guarantee facility?

A credit guarantee facility or program is an intervention by a third-party, in the form of funding, to clientele interest groups such as SMEs, farmers and women (Meyer and Nagarajan, 1996). The third party can either be government or donors. Meyer and Nagarajan (1996) highlighted that it is usually assumed that loans by such clientele groups are perceived to

be risky and this serves as a major impediment to formal sector lending. To reduce the perceived risk, especially of default, the credit guarantee facility is introduced.

In the case of customary land and landowners, there are also perceived risks by lenders. Some risks concerning customary land leases are disputes over land ownership and boundaries; the need for improved management of titles and associated land files at Department of Lands and Physical Planning (Nao, 2021a); and, the adequacy of collateral in securing the loan as well as the capacity of the leaseholder to service the loan (Chand et al., 2014). The call by stakeholders for the government to consider establishing a credit guarantee facility for customary land and customary land leases is worth exploring.

PNG experience with credit guarantee facility

Currently in PNG, there is a government-funded SME credit guarantee facility of K200 million parked with Bank South Pacific (BSP), National Development Bank (NDB) and Department of Commerce and Industry (Chai, 2020). Apart from this, the Government of PNG has teamed up with International Finance Corporation and World Bank to improve access to credit for small and medium enterprises in PNG by providing up to US\$61 million to guarantee 50 percent of bank loans to small and medium enterprises (International Finance Corporation, 2023).

For the purely government-funded facility, funds are available to SMEs and the funds allocated are managed internally by BSP, NDB and Department of Commerce and Industry (DCI), based on their individual lending policies and procedures. From the stakeholder consultations in the above-mentioned NRI study, some lending policies by commercial banks are not client-friendly, such as unwillingness to give loans to start-ups. However, this is not true for all commercial banks. In such instances, the main requirements are evidence of business registration and proof of Taxpayer Identification Number (TIN). There are lessons that can be drawn from the experience of the SME credit guarantee facility that will inform the potential establishment of a credit guarantee facility for customary land.

Potential benefits of a credit guarantee facility for bankable customary land

The proposed credit guarantee facility for customary land has the following potential benefits for customary landowners, investors, banks and the government:

- Improve the livelihoods of customary landowners**
By guaranteeing loans on customary land leases, customary landowners are given increased chances of accessing credit with banks to engage in business. When the loan obtained is applied to its intended use and the land is developed, lease rentals can be paid to landowners, serving as a steady source of income and a means to improve their livelihoods.
- Encourages the mobilisation of customary land for development**
When the supply of credit for development of customary land increases and customary landowners realise an improvement in their livelihoods, it can serve as an incentive for more customary land to be supplied to the formal market for development.
- Serves as an incentive for investment**
By guaranteeing loans, the facility can provide security to new and existing investors and as a result encourage them to invest on customary land. When customary land leases become of secure collateral value, it serves as an incentive for investment on customary land.
- Encourages banks to lend**
The guarantee facility gives comfort to banks to accept customary land leases as collateral and extend credit for development of customary land. The facility also allows banks to provide a new product to its customers and promote its brand.
- Increase revenue for government**
The credit guarantee facility has the potential to increase government revenue from increase in taxes and rates on land as a result of mobilisation of customary land, increase in consumption due to improvement in livelihoods and the availability of more jobs and other income-earning opportunities, and increase in investment from individuals and corporations.

Key considerations to make the credit guarantee facility for bankable customary land work

A credit guarantee facility anywhere has its own set of

challenges. A number of preconditions would need to be met in order for the proposed credit guarantee facility for bankable customary land to be given the best possible chance to achieve its intended outcomes. Levitsky (1997) highlighted that the issue of moral hazard needs to be considered in the design of a credit guarantee facility for SMEs. Meyer and Nagarajan (1996) also highlighted the competing objectives of the three agents – guarantor, lender and borrower as a major factor that needs to be considered and addressed appropriately in the design of a credit guarantee facility for SMEs.

Both factors appear to be relevant for consideration in the design of a credit guarantee facility for customary land in PNG. It is proposed that the government consider these and other factors, including the following:

- Addressing the issue of moral hazard**
Levitsky (1997) defined moral hazard to mean that when borrowers are given guaranteed loans and they are aware that the credit guarantee facility will repay the loan in the event of a default, it weakens their will and commitment to repay the loan. Furthermore, moral hazard is considered on the part of the lender, where the lender has little incentive to effectively supervise the loan and vigorously pursue the collection of the loan.
- Competing objectives of the three agents**
In the credit guarantee arrangements, there are three agents – the guarantor, the borrower and the lender. In this instance, the guarantor would be the government, the borrower would be the customary landowners through their landowner land development company, and the lender would be a bank. Each of these parties have their own set of objectives for engaging in a credit guarantee facility.
- Establishing guidelines**
As with any funding arrangement by the government that involves public monies, there needs to be a set of guidelines established to guide parties in the operation of the facility and the management of the funds. Such a set of guidelines can include steps and requirements to process guarantee claims and undertake debt recovery (Levitsky, 1997).
- Identifying the most appropriate host of the facility**
The host of the credit guarantee facility can be one bank, multiple banks, or another entity deemed necessary to host such a facility. This is the case for the current government-funded SME credit guarantee facility in PNG. For a credit guarantee facility on

customary land, a bank or banking institution would be the most appropriate host of the facility.

- **The sustainability of the fund**

From the outset, at the design stage, it needs to be made clear how long the fund is expected to be in existence and how the fund will sustain itself over time. It needs to be determined how long the government will be providing funding to the facility. If investments will be made by the fund manager and proceeds deposited back in the facility to grow the fund, this will also need to be made clear at the design stage.

Conclusion

A credit facility that allows for leases on customary land to be accepted as collateral by banks by guaranteeing loans in the event of a default could be considered as an option by the Government of PNG to address the issue of unbankable customary land. Introducing such a credit facility for customary land could potentially improve the livelihoods of landowners, encourage the mobilisation of customary land, serve as an incentive for private sector investment, encourage banks to lend, and increase government revenue. However, serious thought must also be given to factors that could potentially impact on the success of the program. These include addressing the issue of moral hazard; ensuring that the competing objectives of the guarantor, lender and borrower are geared towards making customary land bankable; establishing guidelines for such things as guarantee claims and debt recovery; identifying the most appropriate host of the credit guarantee facility; and ensuring that the fund is self-sustaining. It is hoped that this article will contribute to the discussions on addressing the issue of unbankable customary land and effectively mobilising customary land for private sector growth and improved delivery of public goods and services.

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