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Partial Credit Guarantee Schemes & SME Lending

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SME critical for economy, employment & growth ... **but difficult to deal with**

SME plays critical role in economy,

- » employment creation
- » Innovation & incubator for new businesses
- » economic growth, exports, tax

Bank finance is a critical factor for SME growth, both in terms of working capital finance and finance for expansion.

AND: Credit contraction in adverse economic conditions a major obstacles to SME survival & growth

**Employment &
Wages**

**Business growth
→ GDP growth**

**→ Trade & Exports
→ TAX REVENUES**

↑ ↑
**Access to finance
for SMEs**

SME critical for economy, employment & growth ... **but difficult to deal with**

Banks generally accept SMEs as important & profitable client base, with high potential for growth

However, significant challenges in financing the SME sector

Internationally, guarantee funds a preferred policy instrument to support SME finance

Challenges to finance SMEs

- collateral quantity & quality
 - financial statements
 - management changes
 - credit information
- swings in the business cycle
- reg. capital and provisions (Basel II / III + IFRS 9)

contract enforcement & collateral recovery

Partial Credit Guarantee Schemes: long history in OECD & developing countries

- ❖ Japan (1937), USA (1953), Germany (1954), Canada (1961), Italy (1960); France (1971) ...
- ❖ **Value**: risk; collateral; contract enforcement; information exchange
- ❖ **Traditionally govt initiated**, but increasing commercial interest
- ❖ **Guarantee size** from US\$10k to US\$200k+ ... some much larger
- ❖ **Different guarantee products**, sector / population targets, disaster relief, industrial development

Thailand	
Portfolio	\$ 12 bn
# guarantees	330,617
Average	\$ 37,000

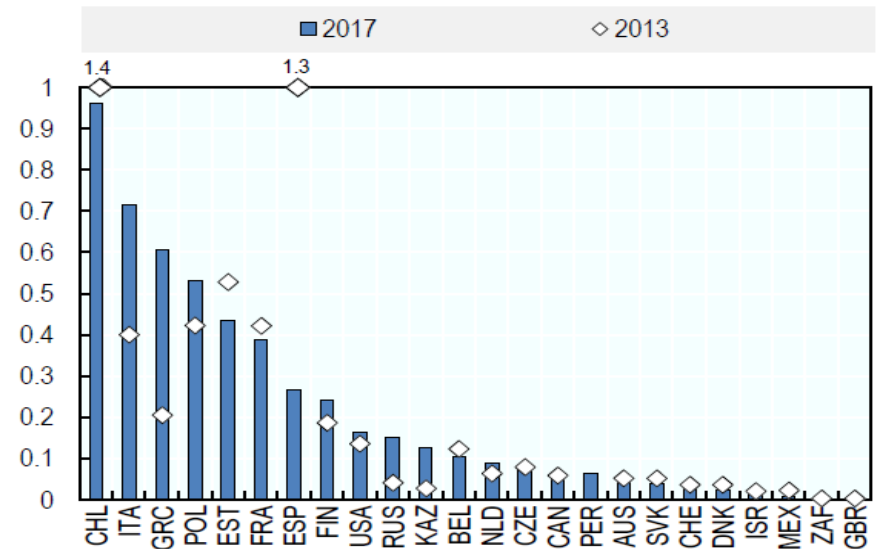
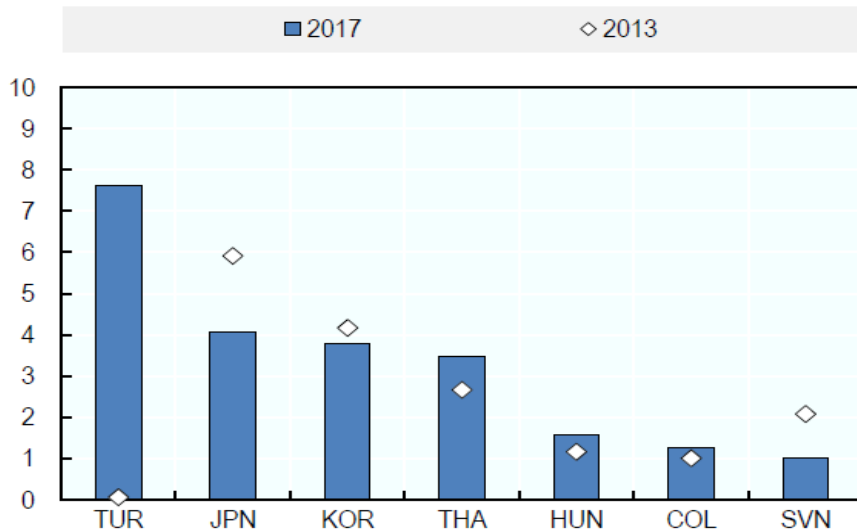
Taiwan	
Portfolio	\$ 24 bn
# guarantees	161,370
Average	\$152,651

Malaysia	
Portfolio	\$ 783 mil
# guarantees	8,999
Average	\$87,000

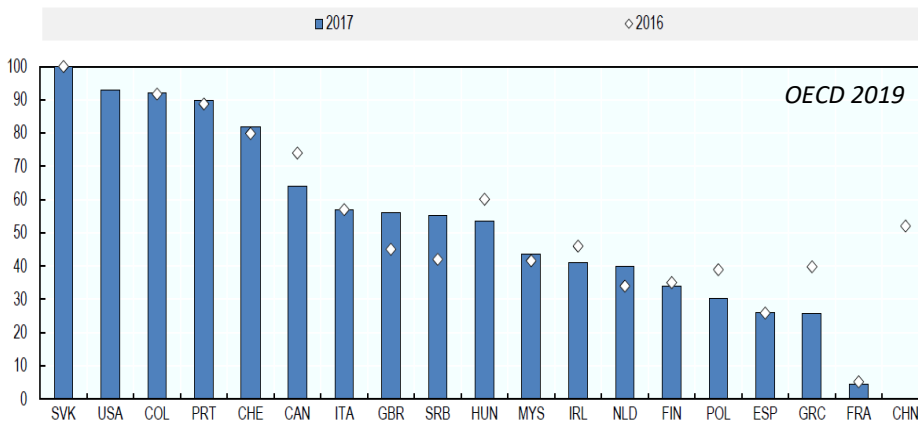
Chile	
Portfolio	\$ 505 mil
# guarantees	32,165
Average	\$15,700

Government Guarantee Funds: Austria, Belgium, Canada, Chile, Colombia, Czech Republic, Denmark, Estonia, Finland, France, Georgia, Greece, Hungary, Ireland, Israel, Italy, Japan, Korea, Malaysia, Mexico, the Netherlands, Norway, Portugal, Russian Federation, Serbia, Slovak Republic, Slovenia, Spain, Switzerland, Thailand, Turkey, United Kingdom, United States ...

Government Loan Guarantees as % of GDP



Share of SME loans requiring collateral



OECD 2019

SME NPL%

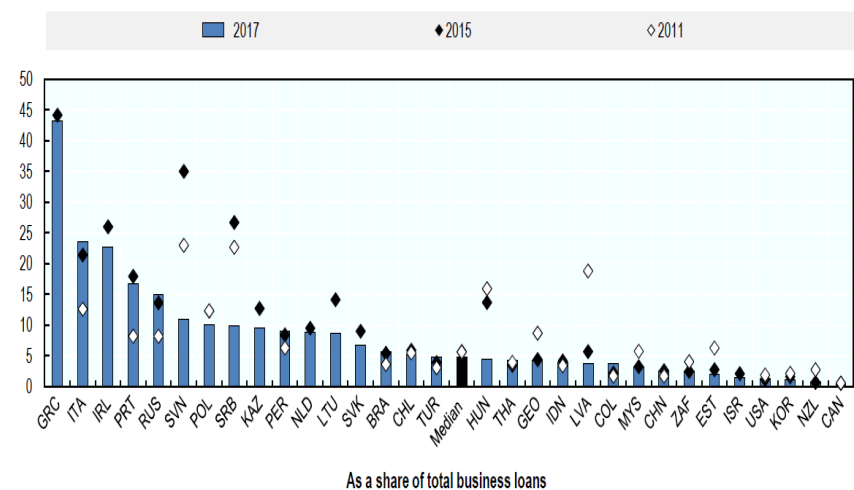
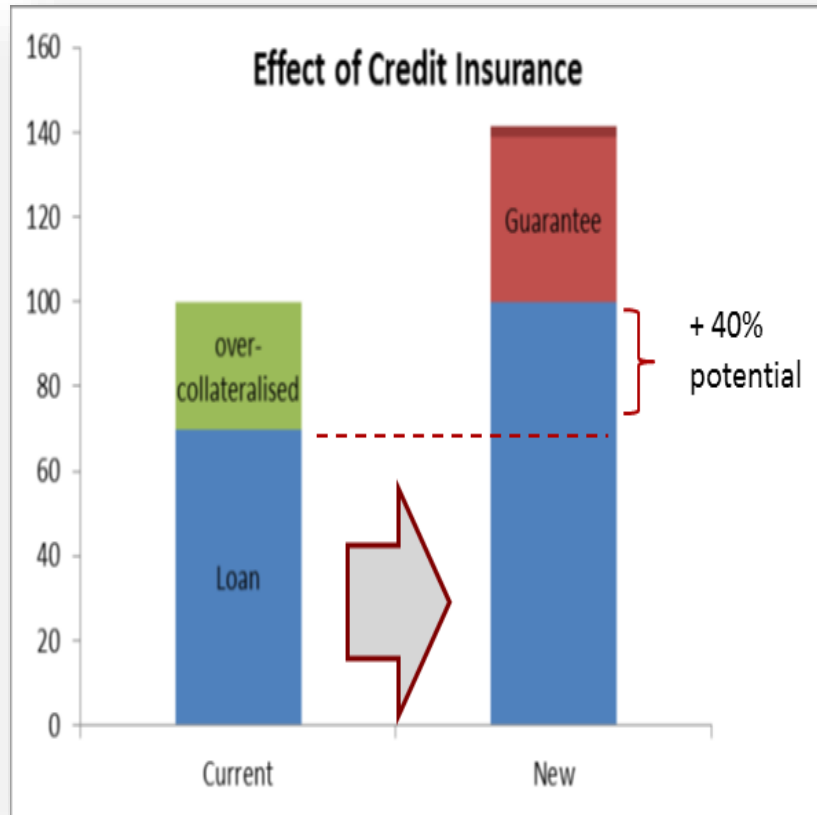


Table 15: Outreach of Guarantee Schemes in Benchmark Countries

	Number of guarantees issued in 2009		Outstanding guarantees in 2009		Average value of guarantees issued in 2009	
	Number	Per million people	Amount in US\$ Million	% GDP	Amount in US\$	Scaled by GDP per capita
Canada	10,000	300	2,000	0.1	100,000	2.5
Chile	60,000	1,800	1,000	0.6	10,000	1.0
France	80,000	1,250	10,000	0.4	60,000	1.4
Hungary	31,000	3100	2,680	1.9	76,500	5.5
India	100,000	100	1300	0.1	10,000	10
Korea	200,00	5,000	50,000	5.0	125,000	7.0
Malaysia	14,000	400	2,000	1.0	66,000	9.4
Netherland	3,200	200	1,500	0.2	230,000	5.0
Taiwan	220,000	8,000	12,000	3.5	50,000	3.0
United States	50,000	130	30,000	0.2	150,000	3.2
Average	62,000	2,100	13,500	1.37	100,000	4.0

Theory of Partial Credit Guarantees



- ☐ Pay-out @ agreed % of net loss, after (bank) enforcement
- ☐ When pay: end of legal process, or 90 day advance payment?

INTENDED IMPACT:

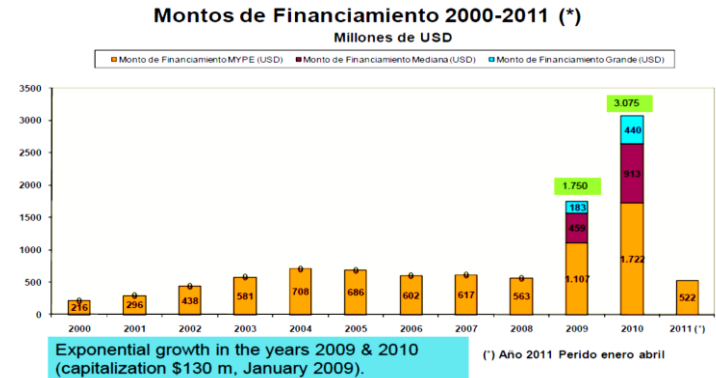
- ☐ Bigger loan (on existing collateral)
- ☐ Higher SME approval rate

Systemic impact over business cycle ...

SMEs: Counter-cyclical impact, prevent credit crunch in economic downturn

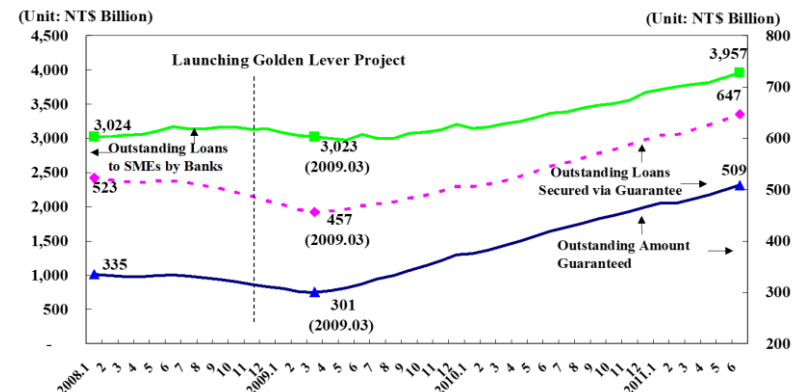
Plus: Reduce risk of bank failure & improve economic & financial sector stability

CHILE



Chile: Portfolio cover, risk based pricing, strong commercial foundation & risk management framework.

TAIWAN



Taiwan: Countercyclical effect after credit contraction, through improved guarantee terms & qualifying criteria

“Additionality”

- ☐ More Credit
- ☐ Increased access
- ☐ Employment
- ☐ Economic impact (SME growth, profits, tax)
- ☐ “Social profitability”

Typical Guarantee Fund & variants

Ownership, Control & Capitalisation

Government, Banking Industry or Joint
Capital of 7% to 25%, mostly gov't transfers (or bank contributions)

Special law; Recognition for bank capital req's?

Donor Funds
SME Associations
Guarantee Banks
Private Guarantee Companies
Reinsurance Capital

Target market & Approval

Only new loans to excluded clients; or current clients?
Sector targeting; gender targeting etc?
Portfolio or individual ... & individual approval?

Allocation by auction
Bank apply for guarantee?
Borrower apply for guarantee?

Coverage, premiums & claim payment

30% - 80% coverage ... after recovery of collateral
Standard or risk based pricing
... advance payment or end payment

Moral hazard & Adverse selection

Independent (professional) management
Performance monitoring

Reduced caution, increased risk profile

Partly policy options ... but huge impact on risk & viability

International: Cost & Risk

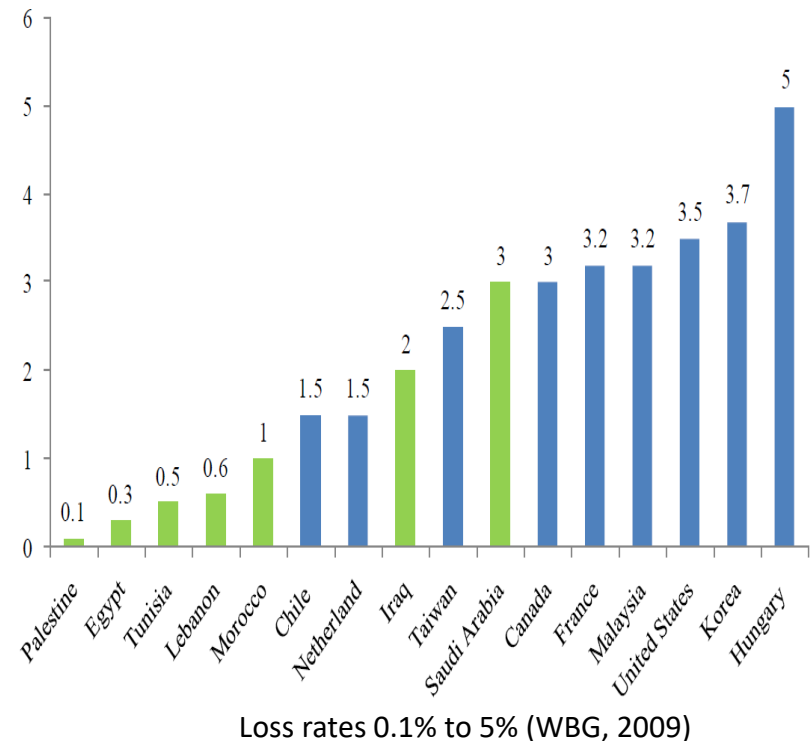
Capital: “Equity Multipliers”
4 to 15 (7% to 25% capital adequacy). Counter-guarantees, increased leverage.

Sound rules and effective risk management \approx net loss ratios below 3% - 4%

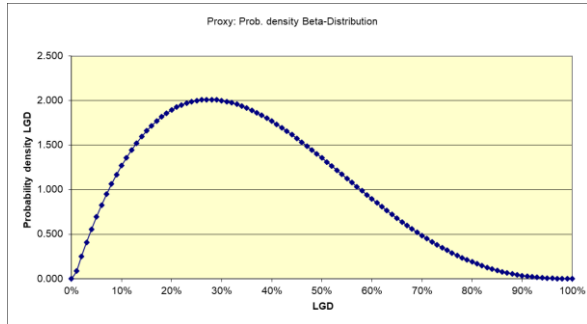
Capitalisation

- Canada and France = budget
- Chile = government equity (\$168 mil)
- Korea 0.3% tax on bank lending

Figure 8: Net loss ratios
(Payment of claims/outstanding guarantees)



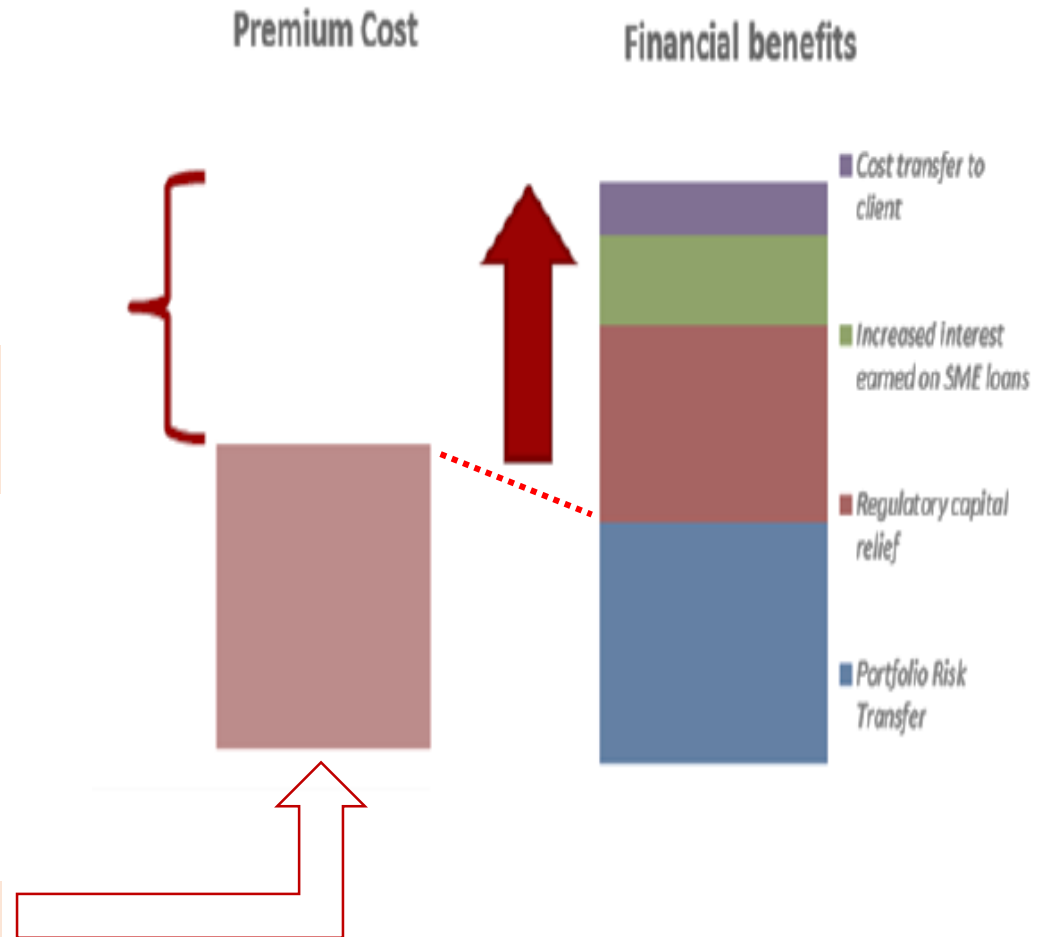
Risk Based Pricing ... Fin value to bank



$PD \times \underline{LGD} = EL$
across business cycle

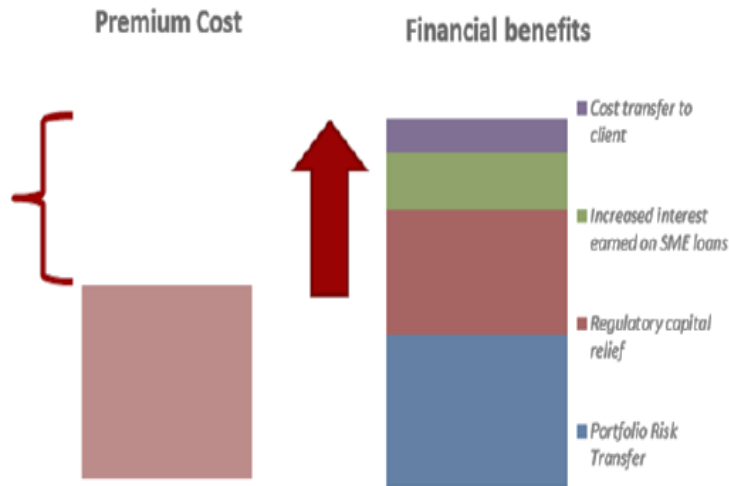
Insurance “margin”
for required “combined ratio”

Guarantee premium



Financial Impact

Increase SME margin from 3% to +10%, after cost of credit insurance,



Income Statement

- ☐ Credit losses
- ☐ Cost of capital
- ☐ Premium pass-through (partial)
- ☐ Margin on improved loan/collateral ratio

Balance sheet

- ☐ Reduce capital requirements
- ☐ Reduce loan loss provisions & IFRS 9 impact

Liquidity

- ☐ Early & predictable payment

Institutional Options

- ❑ **“Commercial approach”**, with independent entity functioning as implementation agency
- ❑ **... stakeholder participation** & profit share ... gov’t, banks, insurers, others?
- ❑ **Gov’t control & gov’t prescription *many risks!***
- ❑ **Central Bank control / oversight:** Internationally, merits, risks ... **compromise**

“The Future”

- ❖ **Risk Based Pricing**, based historic loan portfolio performance (standard Basel assumptions ~ PD/LGD/EL, across cycle)
- ❖ **Risk transfer to international reinsurers**, subject to regulatory requirements
- ❖ **Public & donor funding** to capitalise “risk mitigation fund”, facilitate commercial participation ... catastrophe insurance
- ❖ **Interface with fintech** ... application, info integration, risk assessment, monitoring & administration



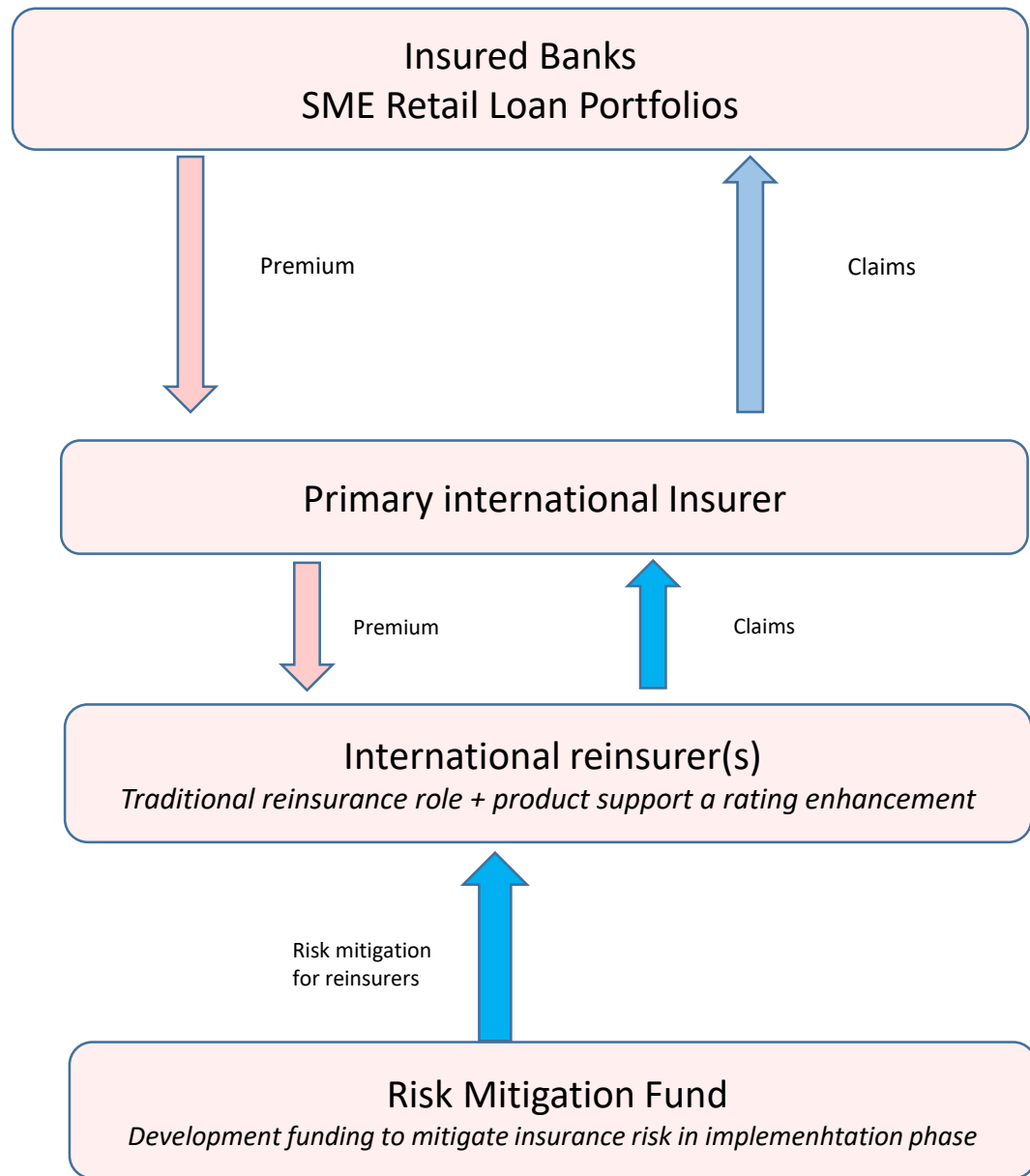
Fund Structure

“Fund Management”

Implementation agency & risk manager

- ❖ Origination support
- ❖ Credit policy & portfolio risk assessment
- ❖ Claims management
- ❖ Risk monitoring & early warning indicators
- ❖ Specialist support to banks & insurers

Extensive collaboration with insurance and SME risk experts, from SA, UK and Germany. Commitment to collaborate in implementation.



Summary

Institutional structure & Governance

Detailed business plan & operational procedures already developed
Different institutional options

Technical design & operational procedures

Complete, based on international best practice (particularly FOGAPE / Chile). Tested against reinsurance requirements based on detailed engagements.

Capital Reinsurance support

Critical, without reinsurance support the facility is not feasible. Preliminary support confirmed, will be involved in final structuring after domestic (bank / government) acceptance & based on hard stats.

Legal & regulatory requirements

Requirements & approval process defined (legal advice & precedent).

- Confirmation of capital relief (product design conform to international requirements)
- Approval for direct risk transfer to international reinsurers

Funding / donor support

Donor funding available, if needed. Potentially applied for:

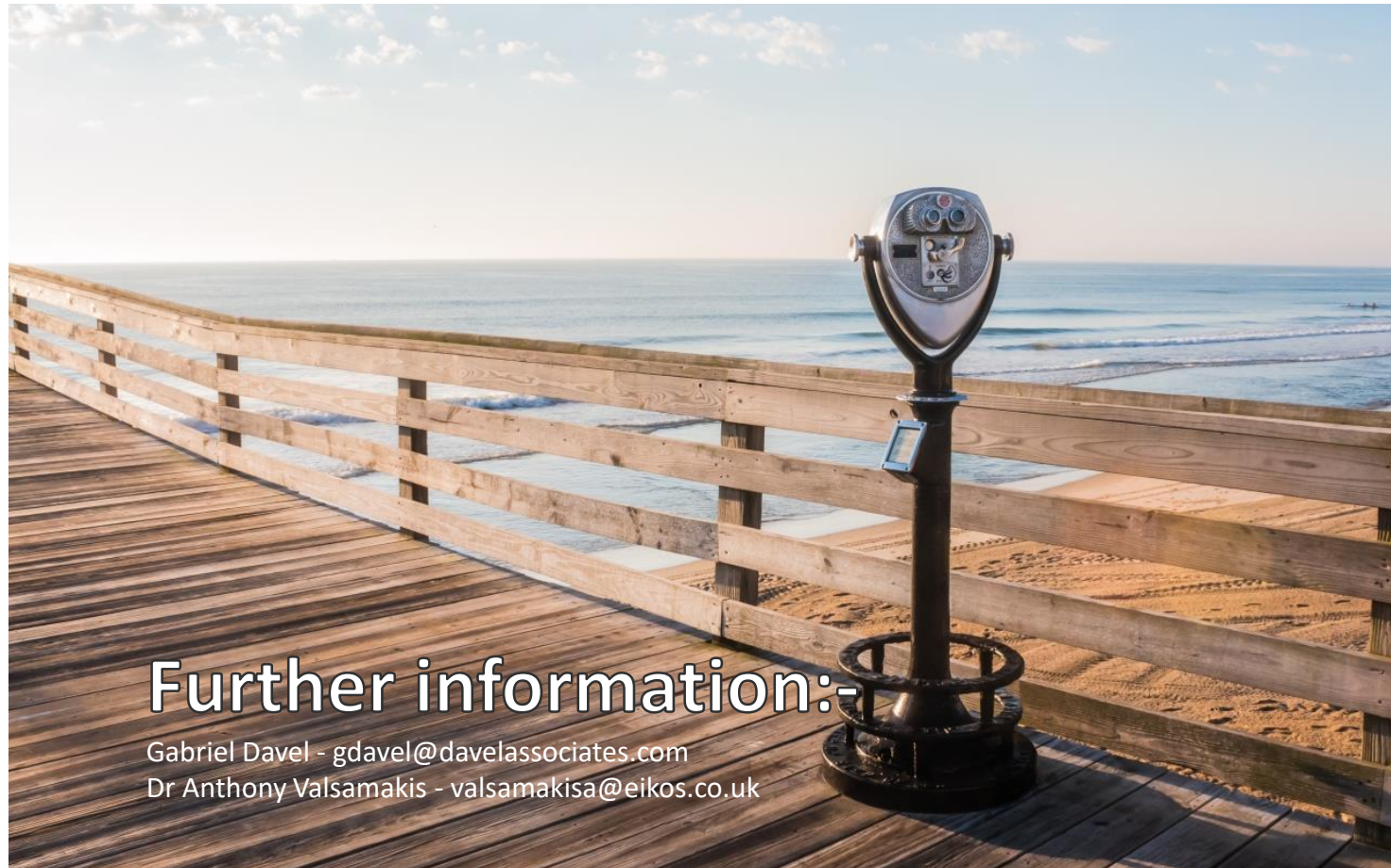
(a) Risk Mitigation Fund; (b) Implementation cost; (c) Incentives for bank participation (subsidies?).

Support from banks

Response has been ambivalent. Somewhat more positive after political changes. But SME clearly not a priority for any bank; and little competitive pressure.

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