November 2019

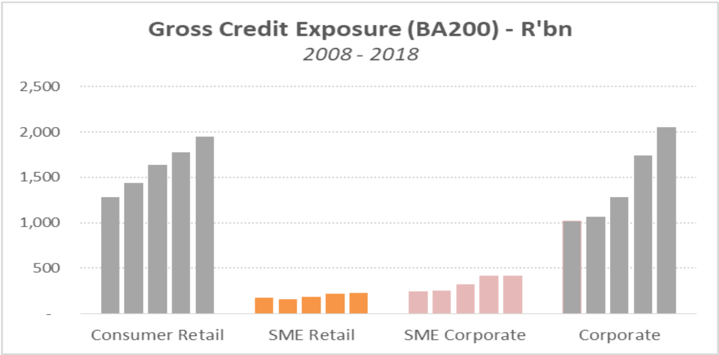
Facility for Credit Risk Mitigation on SME Loan Portfolios

D&A Risk Management

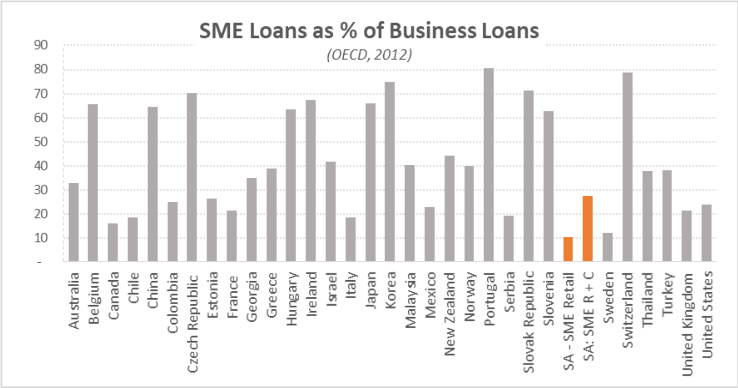
Eikos Risk Capital

SME, employment & credit in SA

- **Extreme constraints on bank credit to SME sector since 2008**. SME Retail grew by only 2.5% per year, declining in real terms and lower than any other category of credit.
- **As % of business credit**, both SME Retail and SME Corporate are well below the comparative levels in OECD as well as most middle income countries
- **SME sector and SME labour absorbtion declined over the same period** (from 62% of private sector employment in 2000 to 55% in 2015), partly due to a sharp increase in SME closure and failure.
- **Contraction in bank credit not the sole reason**, but a significant contributor.



SME Retail static, no real growth since 2008/2010 contraction. Very small compared to other credit segments



SME credit in SA small compared to international benchmarks.

Small/Medium business sector critical for economy, employment & growth

It has long been recognised that the SME sector plays a critical role in the economy, with a key role in different areas

» SMEs play a key role in employment creation
» SMEs play a key role in innovation, as the incubator for new businesses and new innovations
» SMEs play a key role in economic growth and exports

Bank finance is a critical factor, both in terms of working capital finance and finance for expansion. Limited availability of bank finance or credit contraction in times of adverse economic conditions are major obstacles to SME growth and a major reason for SME closure.

Due to strategic importance, substantial domestic and international funding available to support expansion in SME finance

Banks accept SMEs as important and profitable part of the client base, with a high potential for growth in developing markets.

However, significant challenges in financing the SME sector

- Weaknesses in collateral quantity & quality
- Financial statements weak, varying reliability
- Sensitivity to swings in the business cycle
- Sensitivity to management changes
- Credit information incomplete, unreliable
- Risk & cost on contract enforcement & collateral recovery
- High regulatory capital and provisioning requirements (Basel II / III + IFRS 9)

Despite importance, significant challenges in financing SME sector

SME Finance: constraints, risks

Proposition: Credit Insurance on SME Loan Portfolios

An effective National SME Credit Insurance Mechanism will impact in an area of national priority, through unlocking bank lending to the SME sector and addressing national priorities in job creation and business expansion

<u>To SME's</u>: Increased loan access, determined increasingly by debt servicing capacity (not only collateral availability).

<u>To Banks</u>: Significant increase in economic value added for SME Business (30%+). Insurance against default. Improve Credit Risk management. Lower provisions. Lower regulatory capital requirements.

<u>To Economy & Financial Sector</u>: SME growth & job creation; Protection against SME credit contractions; Increase bank stability.

Credit Insurance Facility for bank SME lending: Value for banks

- Credit insurance improve the level and quality of the collateral offered by SME clients and reduces the bank loss in the case of default.
  - Improves collateral of SME clients
  - Enables increased loan size without increasing the loan to value ratio
  - Reduces loan losses & improve credit loss ratio
  - Reduces loan loss provisions
  - Reduces the capital requirement & improves return on capital
- The product is supported by international reinsurers
- Risk management is improved with the support of leading credit bureaus and leaders in SME credit risk management
- *Allows banks to increase SME lending **while reducing risk exposure and losses***

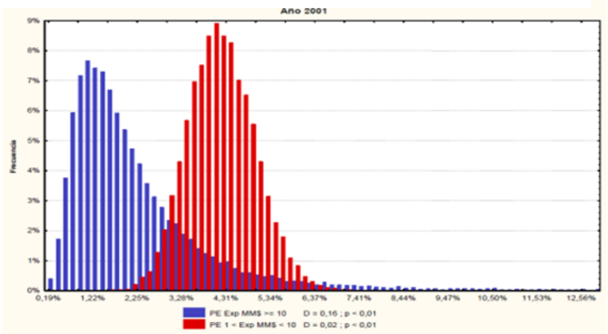
International context

Internationally, guarantee funds play a critical role in bank lending to SMEs

- Guarantee funds mitigate bank risk on lending to SME segment:
- Guarantee funds in most OECD countries; and leading middle income / export orientated countries
- Best practice: professionally managed; portfolio based; pricing based on bank portfolio quality; performance incentives

Country (2009)	Portfolio *USD billion*
USA	$ 30bn
S.Korea	$ 50bn
Malaysia	$ 2bn
Chile	$ 1bn
Taiwan	$ 12bn

Risk profile: SME vs other



International benchmarks

History & track record

Credit Guarantee Schemes have a long history in many OECD and developing countries

- Japan (1937), USA (1953), Germany (1954), Canada (1961), Italy (1960); France (1971). More than 10 years experience in 13 developing countries
- Value: Mitigate uncertainty (perceived risk); Improve collateral; Reduce contract enforcement problems, Economic development. Information benefits through aggregation of information
- Traditionally govt initiated, but increasing interest in commercial participation
- Typical guarantee size from US$10k to US$200k+;
- Gross guarantee portfolios from US$1bn to US$50bn in different countries

Extensive research and benchmark statistics available on all these funds

Table 15: Outreach of Guarantee Schemes in Benchmark Countries

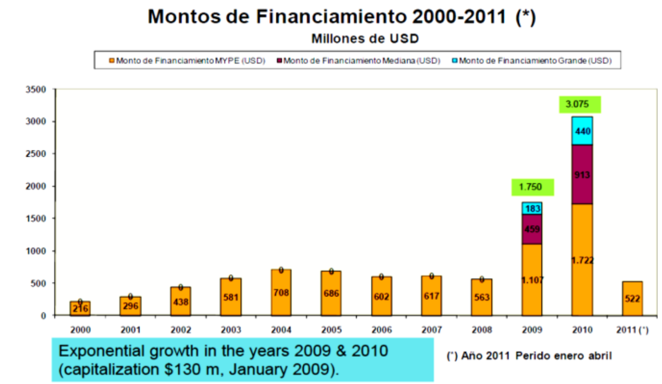
	Number of guarantees issued in 2009		Outstanding guarantees in 2009		Average value of guarantees issued in 2009	
	Number	Per million people	Amount in US$ Million	% GDP	Amount in US$	Scaled by GDP per capita
Canada	10,000	300	2,000	0.1	100,000	2.5
Chile	60,000	1,800	1,000	0.6	10,000	1.0
France	80,000	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

International: Impact

Incentive for bank finance to SME sector = job creation, exports, economic growth, innovation

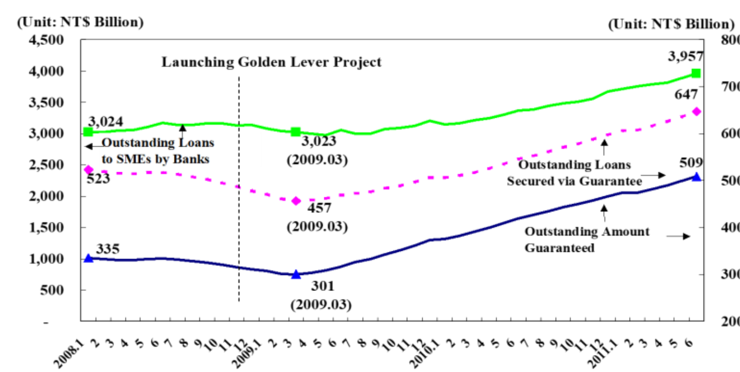
- ❑ Increased lending to existing SMEs + acceptance of previously rejected SMEs
- ❑ Risk transfer: mitigate weaknesses in collateral, countering distress valuations in downturn + substantial regulatory capital relied
- ❑ Strong counter-cyclical impact, preventing credit crunch in economic downturn
- ❑ Strong network effect: improve information sharing on SME risk; improve participation in credit bureaus

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

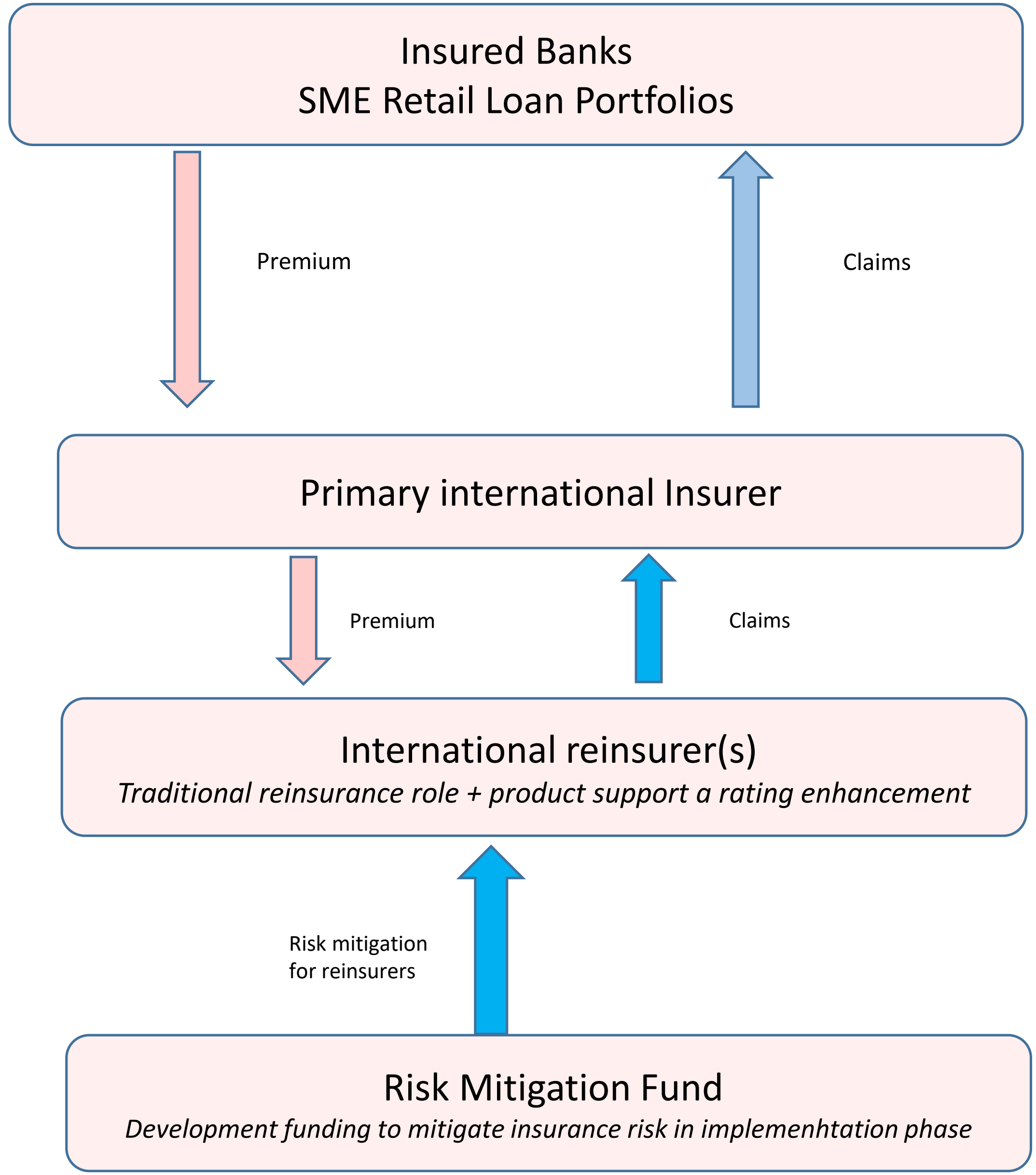
Proposition

Structure

"Guarantee Fund"

Implementation agency & risk manager

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



Features

To provide credit insurance to banks on finance provided to small and medium businesses with 3 foundations:

- ❑ **Sustainable, Commercial Terms**

  Credit insurance on SME loan portfolios, within defined parameters. Insurance provided with substantial risk mitigation, supported by dedicated risk management capacity.

- ❑ **Risk mitigation**

  Substantial risk share between insurance & lenders. Claims levels & loan quality determines future premiums. Additional risk mitigation during inception period through risk mitigation funding provided by international development finance institutions.

- ❑ **Risk management**

  Risk management & claims administration through dedicated risk management structure & agreements with domestic insurers. Strict entry requirements. Minimum approval & loans management procedures. Strict limits on size and terms of insured loans, and collateral requirements. Claims subject to formal claims audits. Portfolio quality & performance monitored through database of loan-level credit information. Exposure & concentration monitoring. Regular engagement with lenders on portfolio performance. Regular portfolio performance reports to insurers & reinsurers.

Value for banks

Primary features of Facility

- Risk transfer to A-rated insurers / reinsurers, at 10% to 50% of portfolio risk (structured based on bank preference) = Basel II/III requirements
- Proposal structured based on profile & performance history of specific bank portfolio
- Supported by a consortium of leading international reinsurers & credit risk managers; implemented through primary domestic insurers

Primary Features	
Portfolio:	SME Retail loan portfolios, loan sizes approx USD5,000 to USD2 mil (adjusted to conform to bank internal definition) Full portfolio, defined segment or new advances only
Security profile	Partially or fully secured loans, related to trade, services, production
Approval requirements	No individual loan acceptance required. Cover subject to compliance with bank credit policy.
Risk transfer	Net risk transfer of 10% to 50%, structured to meet bank requirements Retention: 10% to 75% Risk share net retention: 75% to 10%
Claim payment	Proportional claim payment after final default + share in final surplus / loss after recovery on collateral
Administration	Low cost insurance administration, through customised reporting & claims administration system
Options	Regional portfolios / Keyman insurance / Asset insurance / Share in surpluses

Strategic Value for Bank

Risk reduction, capital release
Net risk reduction, reduced provisions & reduced capital requirements,
deployed in high return / high growth business segment(s)

Improve SME Credit Products
Create superior loan product, with better loan value / collateral offer
at reduced credit risk & capital requirements

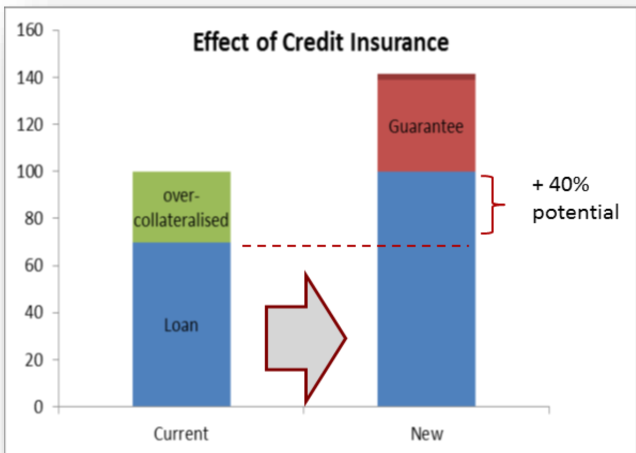
Support growth strategy
Reduce capital requirements for portfolio growth,
limit on maximum credit losses over business cycle

Early warning indicators & risk modelling
specialised credit risk management support, access to SME risk scores,
early warning indicators & portfolio monitoring tools

Incentives to increase SME lending
within framework of best practice in credit risk management, consistent with Basel II standards

FINANCIAL VALUE FOR BANK

- ❑ **Client offering**: *Increase loan size & client acceptance rate, while maintaining required collateral cover.*
- ❑ **Portfolio growth**, *reduced CLR & provision requirements (IFRS 9), reduced capital requirement & improved investor confidence*
- ❑ **Net positive return after cost of insurance,** *improving income statement and balance sheet*



Financial Impact

Financial value for bank

Income statement

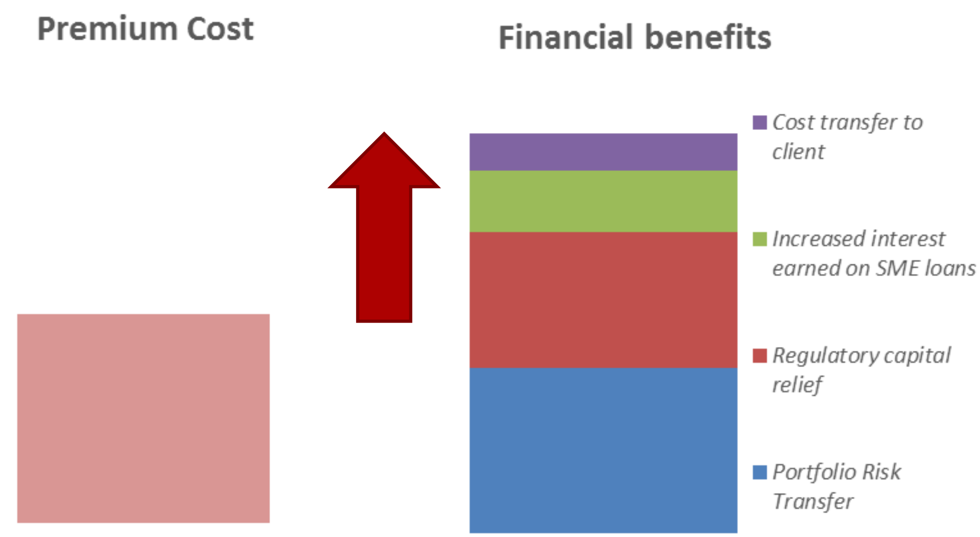
- Reduced losses on SME defaults
- Net impact on income = premium - loss transfer - client margin

Balance Sheet

- Reduced provisions,
- Reduced capital requirement,

Financial Ratios

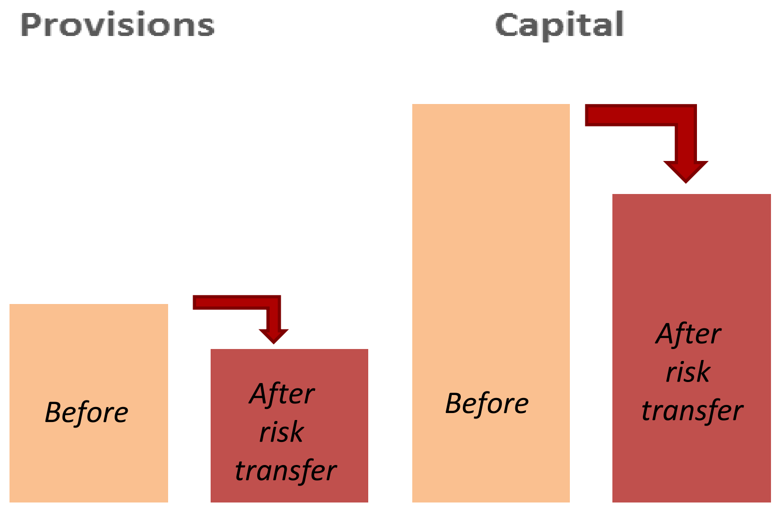
- Improved Credit Loss Ratio
- Improved Return on Capital
- Risk transfer to A-rated International Reinsurers



Potential 4% to +8% improvement in margin on SME loan portfolio

- *Net positive impact on interest margin between 3% and 10%,<u>. after covering cost of credit insurance,</u>*
- *Consisting of premium cost, set off against*
  - *Reduced credit losses*
  - *Reduced capital requirements & cost of capital*
  - *Premium pass-through (partial)*
  - *Margin on improved loan/collateral ratio*

Income Statement



Comparison: before and after risk transfer

Potential 10% to 50% reduction in provisions & capital requirements => Improved ROE & ROA

- *Reduced provisions & reduction in capital requirements:*

  = <u>reduce between 10% and 50%</u>, depending on selected risk transfer structure

- *Reduction in effective cost of capital*
- *Significant improvement in ROE & ROA*

Balance Sheet

Implementation Partners

» **Gabriel Davel**, *previous CEO of the National Credit Regulator is leading the initiative*

» **Dr Anthony Valsamakis** *(Eikos Risk Capital), leads the insurance structuring and reinsurance broking. Dr Valsamakis has a long track record in both the SA and UK insurance markets. Previous engagement with Guy Carpenter, Scor & others*

» **Dr Frank Broker,** *(Germany) leads the technical credit risk analytics. Dr Broker is a specialist in credit risk analytics and previous head of risk analytics & scorecard development for Schufa (leading German credit bureau)*

» **Mr Patrick Bracher** *(Norton Rose Fulbright) advised on all areas of legal structuring and compliance. Mr Bracher is a prominent financial services and human rights lawyer in South Africa*

» **Donor support**: *Potential, depending on target market*

Implementation Partners

Thank You

Further information:-

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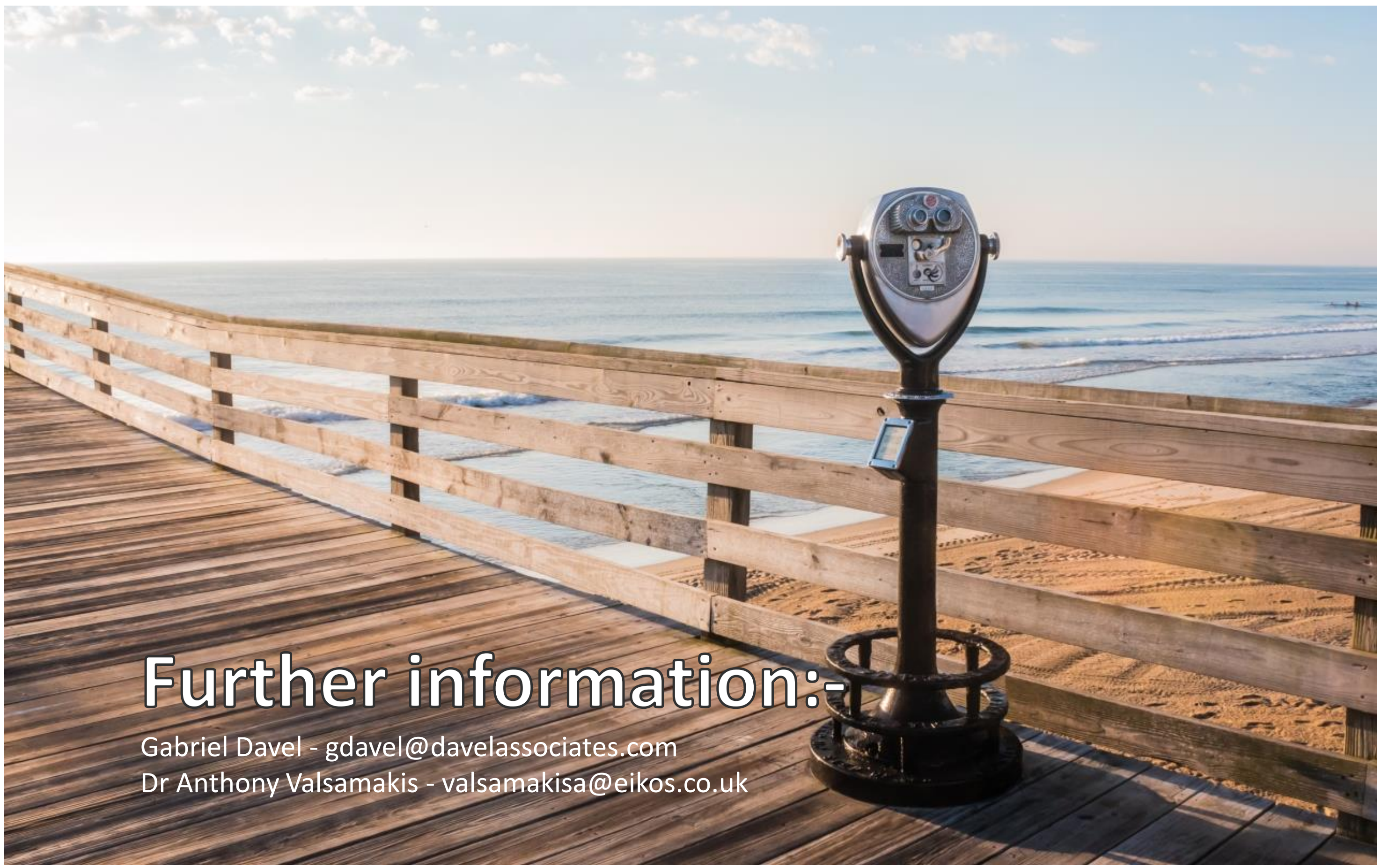

Further information:-

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Associated Institutions

Consortium Leader: Gabriel Davel

The implementation is lead by Gabriel Davel, a previous partner at Deloitte & Touche Financial Institutions Team (Johannesburg) and previous CEO of South Africa's National Credit Regulator. Gabriel is a qualified chartered accountant and has further degrees in Statistics, Economics, Econometrics and Development Finance. He has extensive experience in financial regulation and credit market development in Africa, Central Asia and Asia.

Insurance Risk Transfer Structure: Dr Anthony Valsamakis

The Facility is being implemented with the support of Dr Anthony Valsamakis and Eikos Risk Capital. Dr Valsamakis is Executive Chairman of the Eikos group of companies and is an internationally recognised insurance risk management professional and pioneer in cell-captive structures. He has offices in London and Johannesburg.

Risk modelling & risk monitoring: Dr Frank Bröker / SCHUFA HOLDING AG

Risk modelling, monitoring and reporting is lead by Dr Frank Bröker and SCHUFA Holding AG. SCHUFA is the leading credit bureau and scoring services provider in Germany and internationally. Regional expert support in portfolio risk assessment and risk monitoring is provided by ScoreSharp, a South African specialist credit risk management consultancy.

Implementation Support: ……….

The implementation of the Facility is supported by …….