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Partial Credit Guarantee Schemes & SME Lending

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EXECUTIVE SUMMARY

- ❖ **Internationally**, SME sector a national priority, impacting job creation, economic growth, tax revenues etc. **Guarantee Funds are preferred policy instrument**. Significant funds in nearly all OECD countries.
- ❖ **SME sector in SA in desperate state**: contraction, job losses, access to finance.
- ❖ **Potential to establish a world-class guarantee fund with international reinsurance support**. Despite negative perceptions, potential international reinsurance capacity of R100 bn +
- ❖ **Critical conditions:-**
 - Institutional support (in SA)
 - Will banks support the initiative?
 - Will guarantees qualify for capital relief (SARB / PA)
 - Regulatory dispensation to place insurance with international reinsurers (SARB / PA)
- ❖ **Question**: Is there support for a “National Initiative”, at scale?

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

[PSD2 / Open Banking: importance in a banking monopoly & growth of fintech]

SMEs finance: Challenges

contract enforcement & collateral recovery

swings in the business cycle / sector impact / contraction

collateral quantity & quality
→ distress valuations

financial statements, credit information
→ risk assessment

impact of management changes

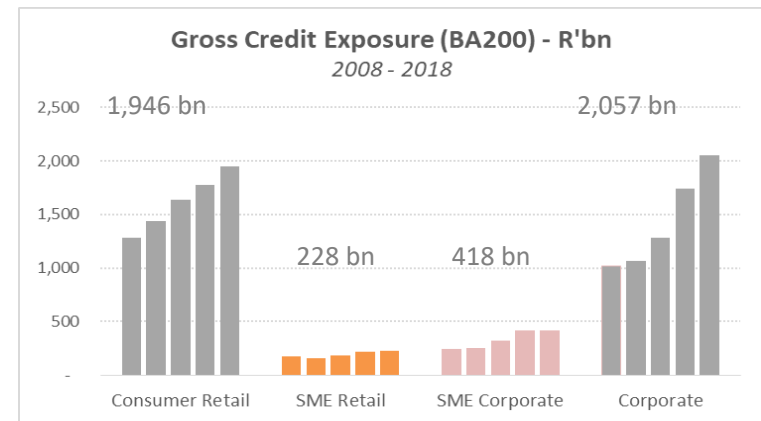
reg. capital and provisions
(Basel II / III + IFRS 9)

South Africa:

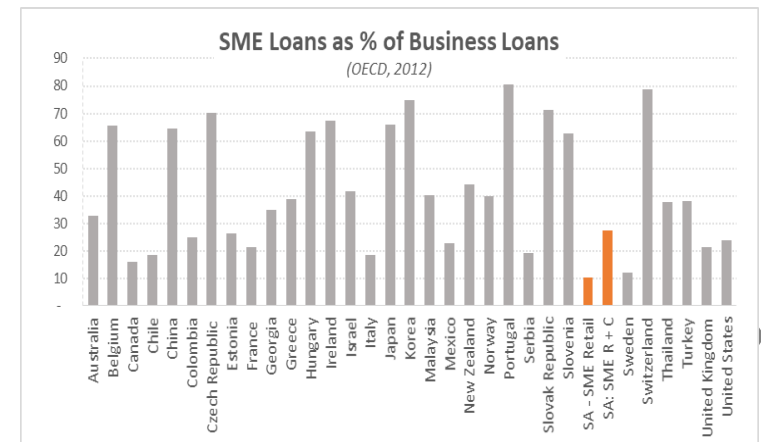
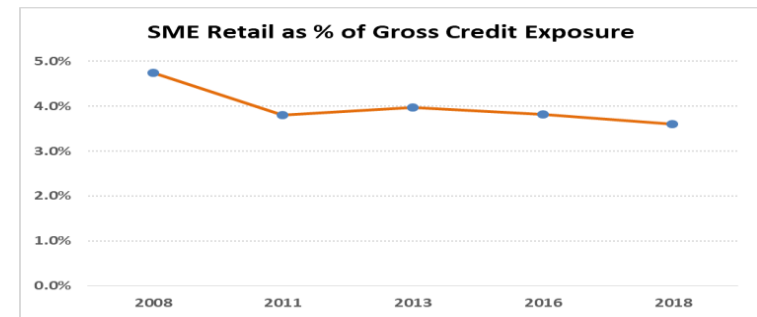
SME contraction & impact on job
creation & growth

SME, employment & credit in SA

- ❑ **Decline in SME sector & labour absorption** (62% of private sector employment in 2000 to 55% in 2015).
Sharp increase in SME closure and failure
 - jobs lost: 1 mil +
 - losses in GDP, export & tax
- ❑ **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 well below comparative levels in OECD and most middle income countries
- ❑ **Contraction in bank credit** not only constraint to SME growth, but significant contributor.
- ❑ **... & SA's Khula Guarantee Fund: Small, terrible reputation, no impact**



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.

Potential national impact from effective SME growth strategy

Key SME Stats (BER, Stats SA, SEDA)

SMEs (formal) 600,000 +

Employment 4.97 mil

Wages R 155 bn

GDP contribution R 523 bn

Tax contribution (corporate & VAT) R 161 bn

Key SME Stats	2020 <u>R ' mil</u>	20% <u>growth</u>	<u>5 years</u>
Turnover	973,000	194,600	973,000
GDP contribution	523,000	104,600	523,000
Capital expenditure	21,000	4,200	21,000
Tax - corporate	15,000	3,000	15,000
Tax - VAT	145,950	29,190	145,950
Employment	4,972,307	249,000	+ 5%
Wages	155,000	31,000	155,000

Stats based on BER 2016 & SEDA 2018, adjusted for inflation

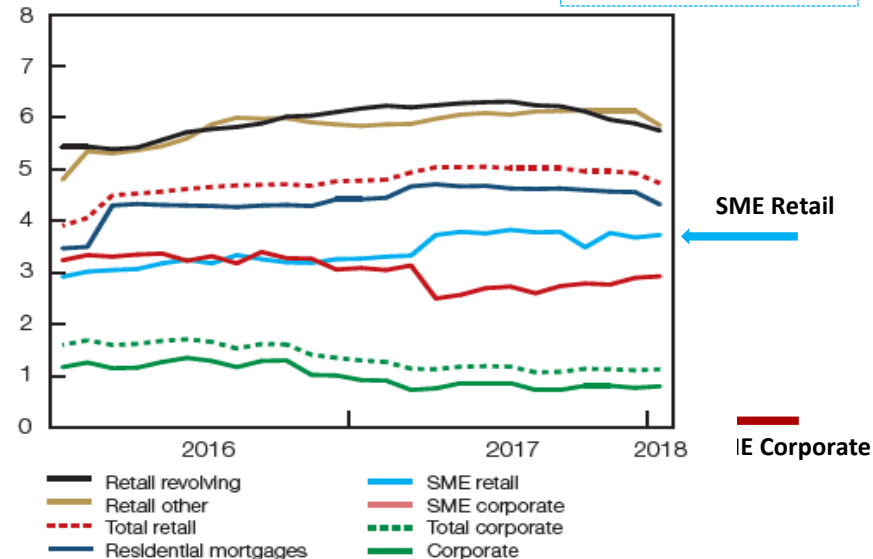
SA Default rates, SME lending

- ❑ SA's expected losses in SME sector low by international standards, including EU standards
- ❑ Based on loss expectations, every reason why lending should increase

HOWEVER

- Level of competition very low
- Profitability of alternative products extremely high
- Sophistication in SME risk analytics low
- No sharing of business credit information
- Extreme caution for fear of negative impact of external & business cycle risk factors on SME
- Extreme caution of negative impact of government policies on SME

Figure 14 Default credit ratios
Per cent



- ❑ Credit loss rates (CLR) on SME for different banks from as low as 0.3% to around 2.5%
- ❑ Mostly well below target loss rates

➔ **Problem:** Conservative lending philosophy, rather than inherent risk

SARB Statistics on Banking Sector Credit (BA200)					
Gross Credit Exposure (BA200) - R'bn	<u>2008</u>	<u>2011</u>	<u>2013</u>	<u>2016</u>	<u>2018</u>
Consumer Retail	1,286	1,436	1,639	1,777	1,946
SME Retail	179	159	187	220	228
Total Retail	1,465	1,595	1,826	1,997	2,175
SME Corporate	245	253	325	418	418
Corporate	1,018	1,070	1,279	1,738	2,057
Total Corporate	1,263	1,323	1,604	2,157	2,475
Other	1,040	1,263	1,275	1,616	1,684
Gross Credit Exposure	3,768	4,180	4,705	5,769	6,333
SME Retail as % of Gross Credit Exposure	4.7%	3.8%	4.0%	3.8%	3.6%
			<u>aggregate</u>		<u>annual</u>
Growth in SME Retail: 2008 to 2018			27.8%		2.5%
<i>Growth in Consumer Credit (incl mortgages): 2008 to 2018</i>			51.3%		4.2%
<i>Growth in Corporate Credit: 2008 to 2018</i>			102.1%		7.0%



Partial Credit Guarantee Funds: International context

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, for specific objectives:** sector / population targets (Bumiputera in Malaysia), 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

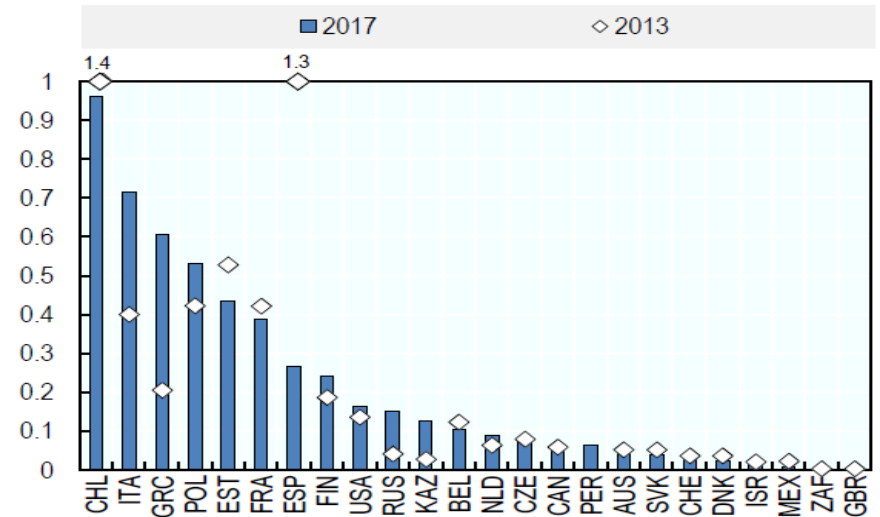
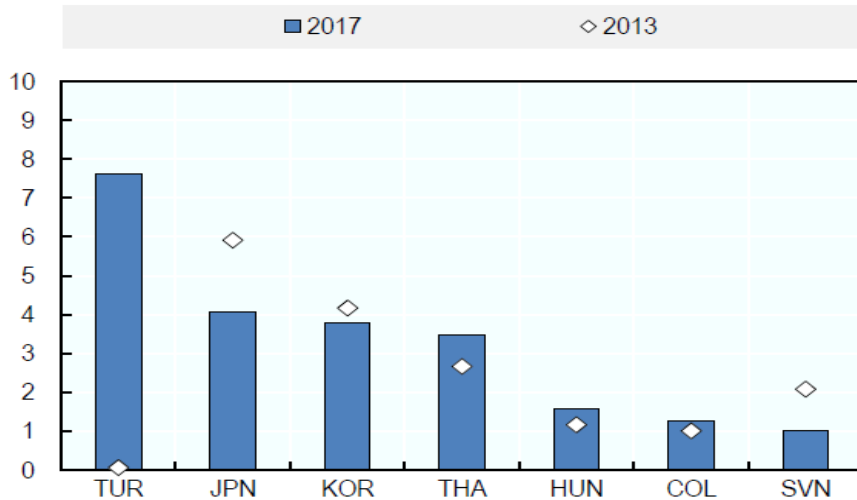
Portfolio	\$ 505 mil
# guarantees	32,165
Average	\$15,700

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 ...

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

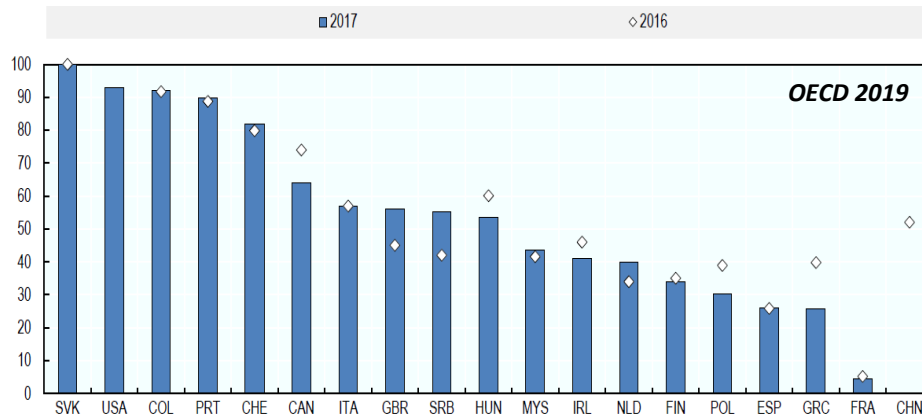
Government Loan Guarantees as % of GDP



SME's requiring collateral / SME loss rates

Share of SME loans requiring collateral

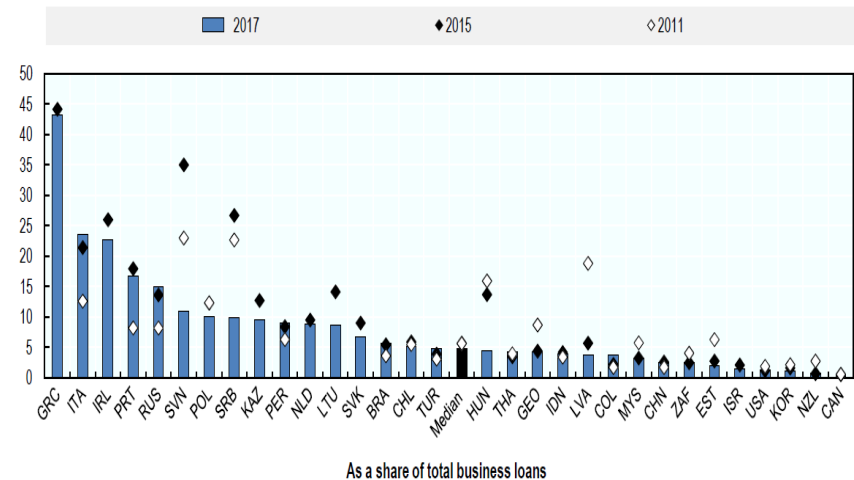
Share of SME bank loans requiring collateral, in percent



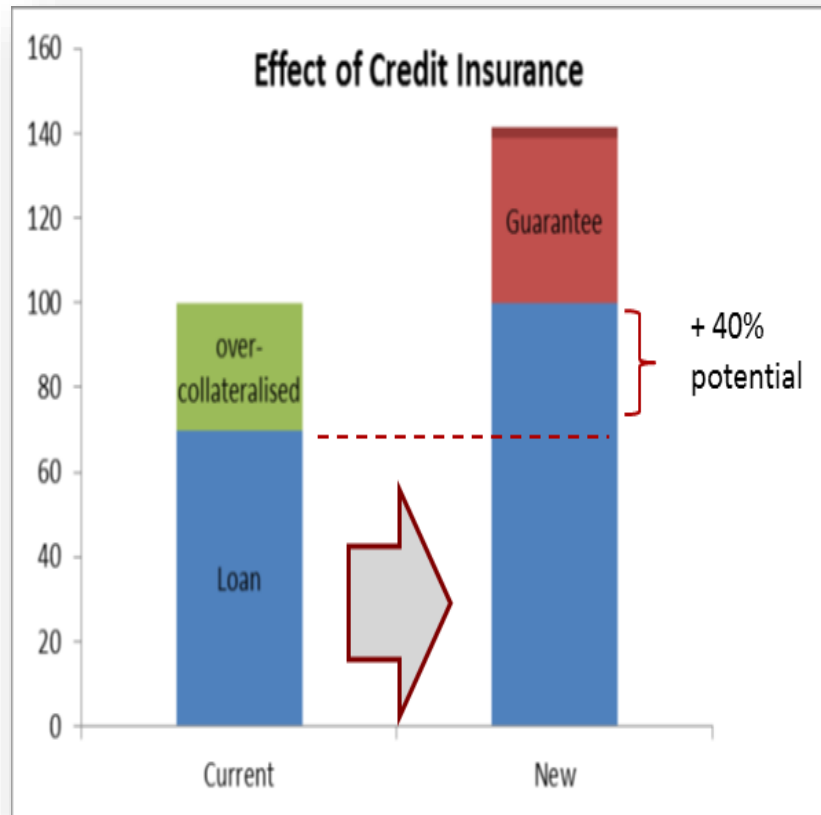
OECD 2019

SME NPL%

As a share of total SME loans



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:

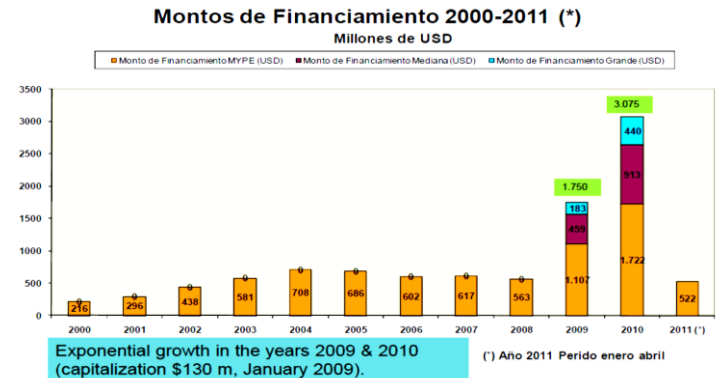
- ❑ Bigger loan (on existing collateral)
- ❑ Higher SME approval rate

Systemic impact over business cycle ...

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

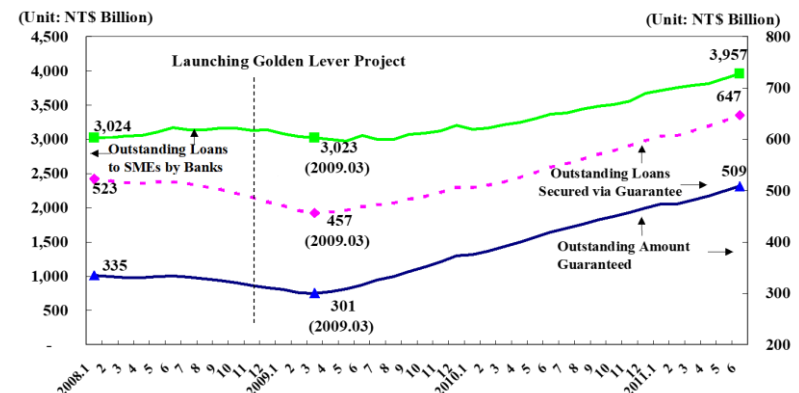
Plus: Reduce risk of bank failure & improve economic & financial sector stability

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

International: Cost & Risk

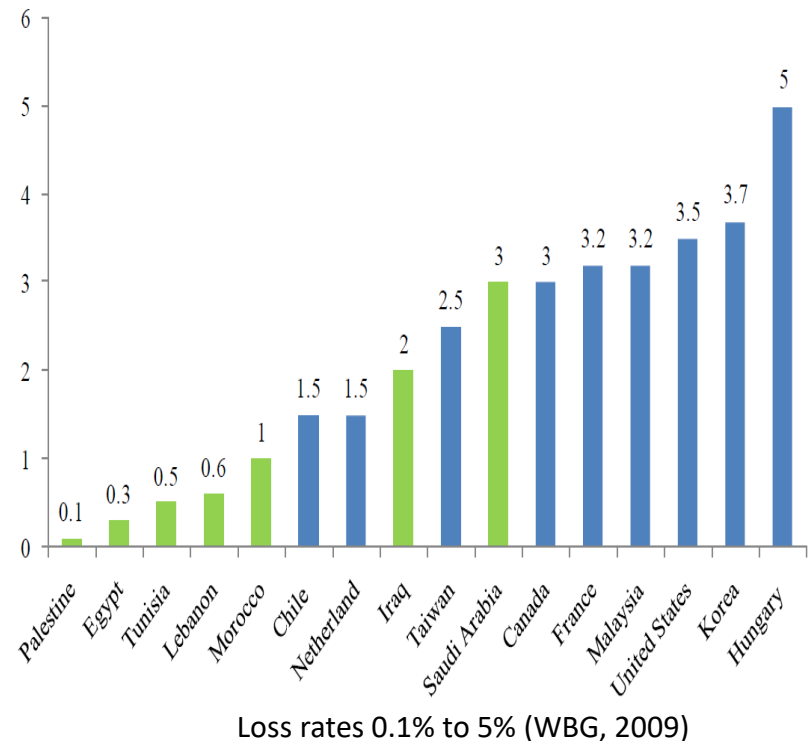
Capital: “Equity Multipliers”
4 to 15 (7% to 25% capital adequacy). Counter-guarantees, increased leverage.

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)



“Additionality” from well-structured guarantee fund

- ☐ 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?

Target market & Allocation

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



Donor Funds
SME Associations
Guarantee Banks
Private Guarantee Companies
Reinsurance Capital

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

Typical Guarantee Fund & variants

Coverage, premiums & claim payment

30% - 80% coverage ... after recovery of collateral

Standard or risk based pricing

... advance payment or end payment

Independent (professional) management

Performance monitoring

Allocation by auction
Bank apply for guarantee?
Borrower apply?

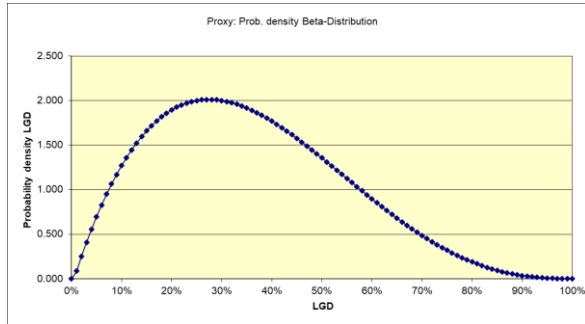


Moral hazard & Adverse selection

Caution in lending - risk profile

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

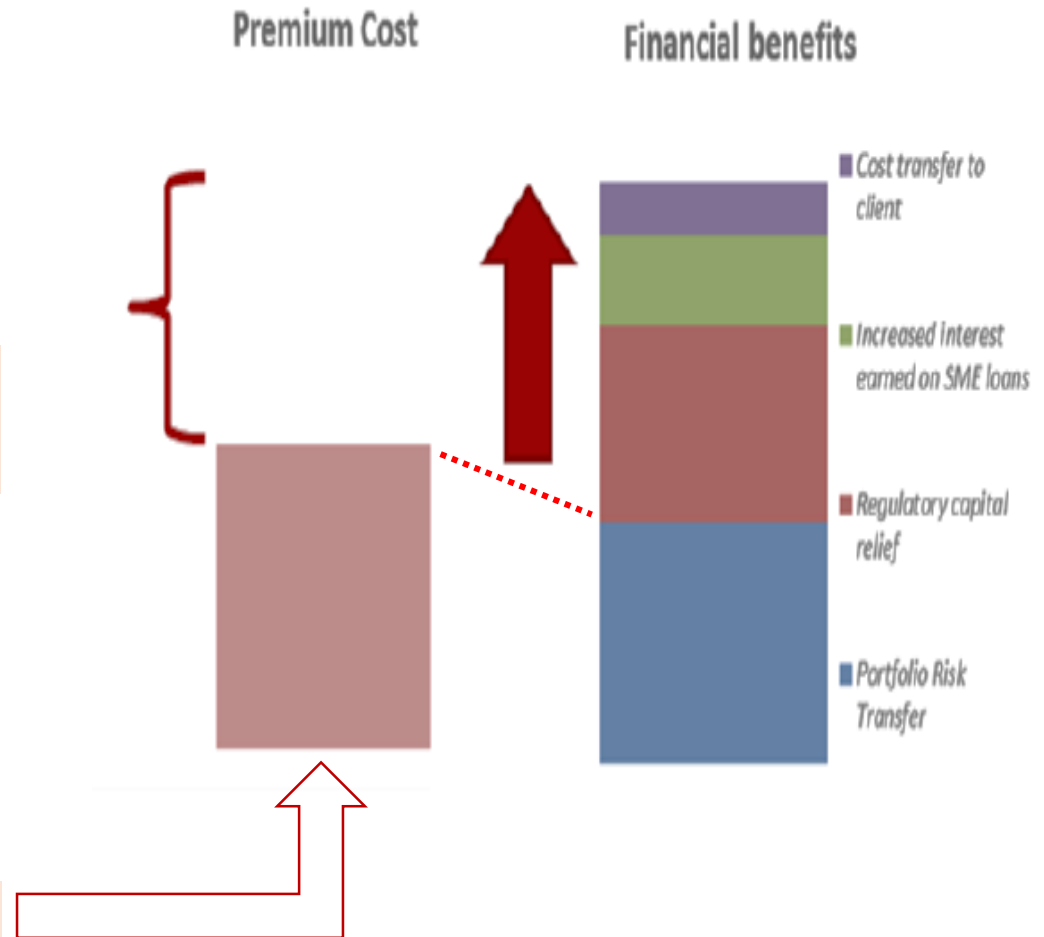
Risk Based Pricing ... Fin value to bank



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

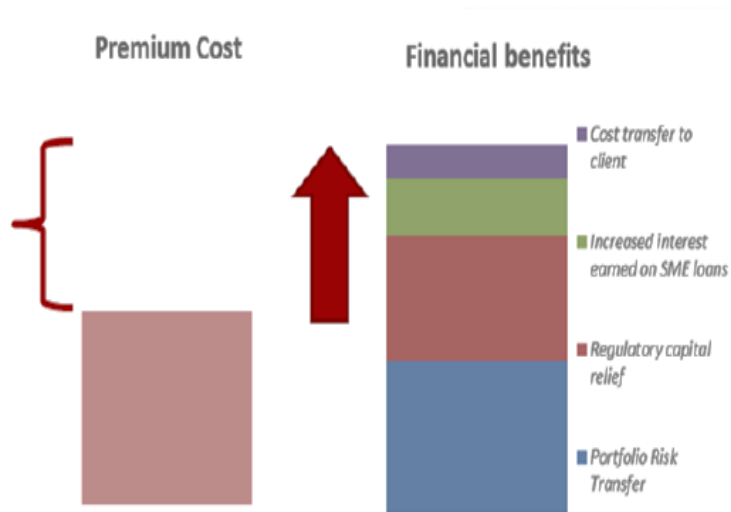
Insurance “margin”
for required “combined ratio”

Guarantee premium



Financial Impact

Increase of bank margin on SME lending 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

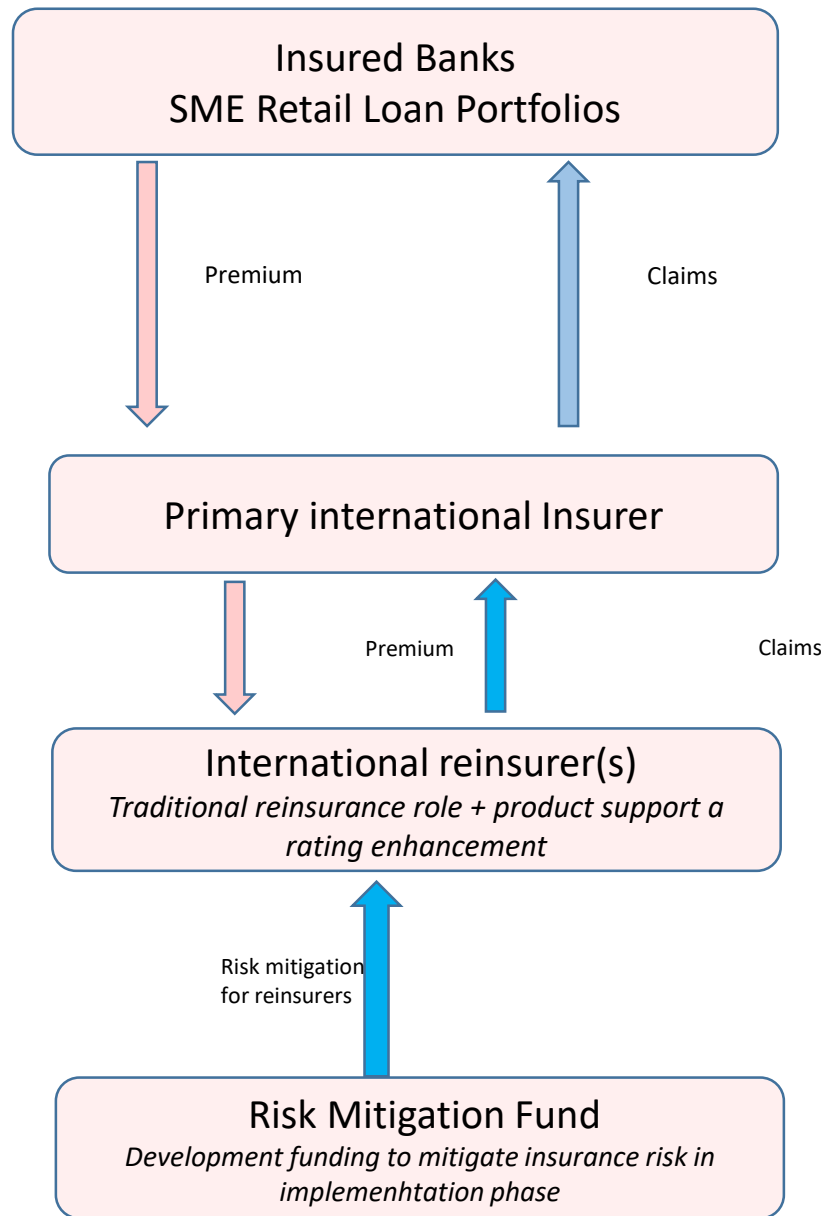
Proposed “Best Practice” Approach

“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.



Appetite?

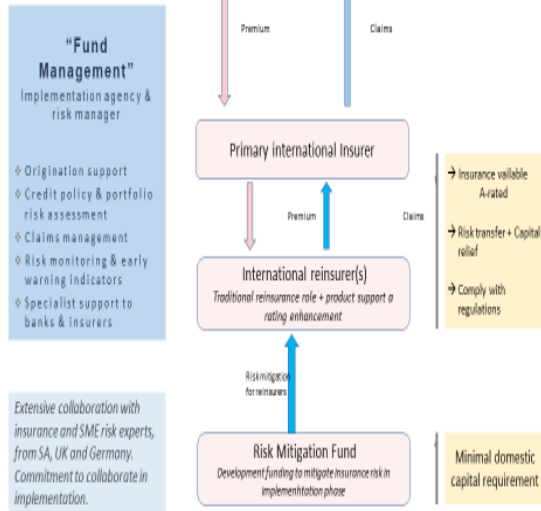
→ Insurance available A-rated

→ Risk transfer + Capital relief

→ Comply with regulations

Minimal domestic capital requirement

Modern Approach



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Option for SME Targeting

- ❖ Offer guarantees directly to SMEs, through fintech application
- ❖ Avoid banks playing "gate keepers", improve competitive engagement
- ❖ Include all SMEs in scope, with price incentive for BEE

[adverse selection & moral hazard ... SME vs bank, which is greater??]

Institutional Structure

- ☐ Separate (new) company, independently managed & dedicated to managing credit insurance
- ☐ Two options: (a) Entirely private (with institutional support); or (b) Government shareholder, with institutional participation
- ☐ Minimum capital requirement: (a) to facilitate entry into reinsurance market (b) to fund non-commercial risk classes
- ☐ Reporting to Central bank, to support recognition for capital relief (subject to compliance with existing conditions).
- ☐ Regulatory approvals: (a) Capital Relief; (b) “Dispensation” for international reinsurance placement

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:

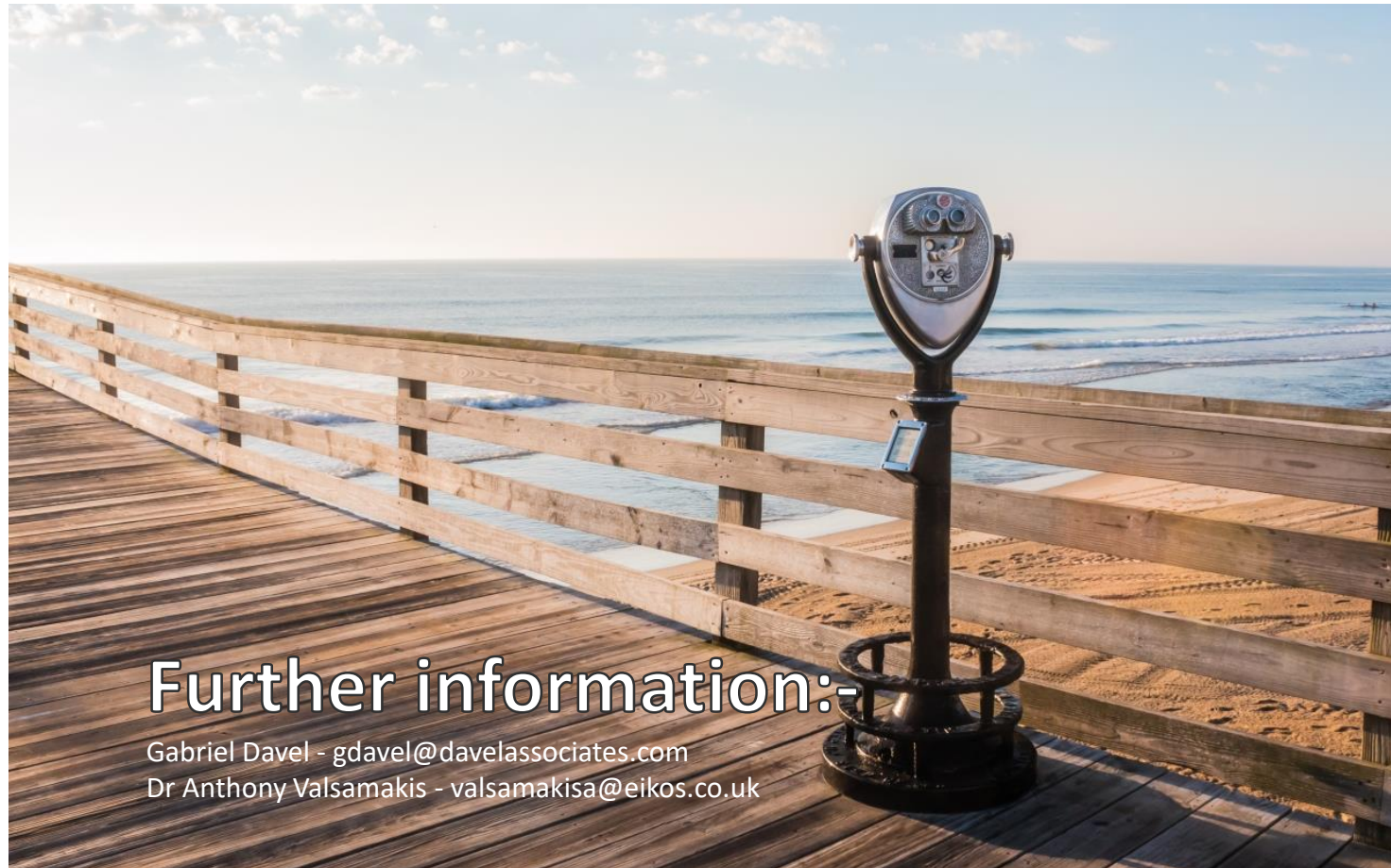
(a) Risk Mitigation Fund; (b) Implementation cost; (c) Incentives for bank participation (subsidies?).

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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Further information:-

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Annexure

Regulatory requirements

1 - Counterparty requirements: International + Rating

2 – “Guarantee Requirements” (SARB / Basel)

Documented, enforceable,
direct, explicit, irrecoverable,
unconditional (& compensatory
bank risk management) [p127]

3 – Dispensation for direct placement with international insurers & reinsurers

Table 8
Credit assessment issued by eligible institutions¹

Claim in respect of-	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Sovereigns (including the Central Bank of that particular country)	Export Credit Agencies: risk scores¹					
	0-1	2	3	4 to 6	7	
	0%	20%	50%	100%	150%	100%
Public-sector entities	20%	50%	50%	100%	150%	50%
Banks^{2, 4, 5}	20%	50%	50%	100%	150%	50%
Securities firms^{2, 4, 5}	20%	50%	50%	100%	150%	50%
Banks: short-term claims^{3, 4}	20%	20%	20%	50%	150%	20%
Securities firms: short-term claims^{3, 4, 5}	20%	20%	20%	50%	150%	20%
Corporate entities^{2, 4, 7, 8}	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-		
	20%	50%	100%	150%		100%
Banks and corporate entities	Short-term credit assessment^{1, 4, 9}					
	A-1/P-1	A-2/P-2	A-3/P-3	Other		
	20%	50%	100%	150%		

(ee) another financial institution, including an insurance company, eligible for a risk weighting of 20 per cent in terms of the simplified standardised approach;

(ff) regulated mutual funds that are subject to capital or leverage requirements;

(gg) regulated pension funds;

(hh) any clearing institution approved in writing by the Registrar.

When a bank complies with all of the requirements specified above but the repurchase or resale agreement was concluded with a counterparty other than the counterparties specified above, the bank may assign a risk weighting of ten per cent to the protected portion of a credit exposure or potential credit exposure.

(c) Guarantees

(i) Risk weighting

When a bank obtains protection against loss relating to an exposure or potential exposure to credit risk in the form of an eligible guarantee, the risk weight applicable to the guaranteed transaction or guaranteed exposure may be reduced to the risk weight applicable to the guarantor in accordance with the provisions of this paragraph (c).

The lower risk weight of the guarantor shall apply to the outstanding amount of the exposure protected by the guarantee, provided that all the requirements set out in this paragraph (c) are met.

(ii) Proportional cover

When a bank obtains a guarantee for less than the amount of the bank's exposure to credit risk, the bank shall recognise the credit protection on a proportional basis, that is, the protected portion of the exposure shall be risk weighted in accordance with the relevant provisions of this paragraph.