European Banking Coordination (Vienna 2) Initiative

Working group on credit guarantee schemes

Meeting of the VI2 Full Forum, 12 November 2014, Brussels

Summary and conclusions of the WG report

Aurora Ferrari (WG), Paweł Gąsiorowski (NBP), Áron Gereben (EIB)

EBCI Vienna Initiative

European Commission · European Investment Bank · European Bank for Reconstruction and Development · International Monetary Fund · World Bank Group

Background

- WG established by the VI2 Full Forum in November 2013.
- The aim was to explore the possible role of credit guarantee schemes (CGSs) in alleviating the low supply of credit in the CESEE.
- 2 physical meetings (November 2013, September 2014).
- Data sources: 3 surveys – CGSs, banks, regulators.
- EC/EIF data for additionality measurement of SMEG guarantees.
- Key contributors: EIB, NBP, World Bank
- Participation of all other VI2 stakeholders
- Inclusion of stakeholders outside the VI2 circle, such as AECM, OECD & EBA etc.

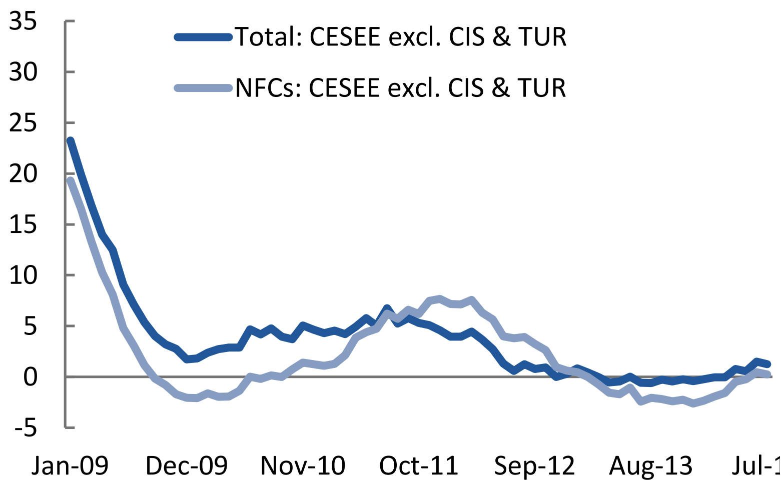
Structure of the presentation

1. The credit guarantee landscape in the CESEE
2. Current issues and challenges
3. Conclusions and recommendations

Bank lending in CESEE after the crisis

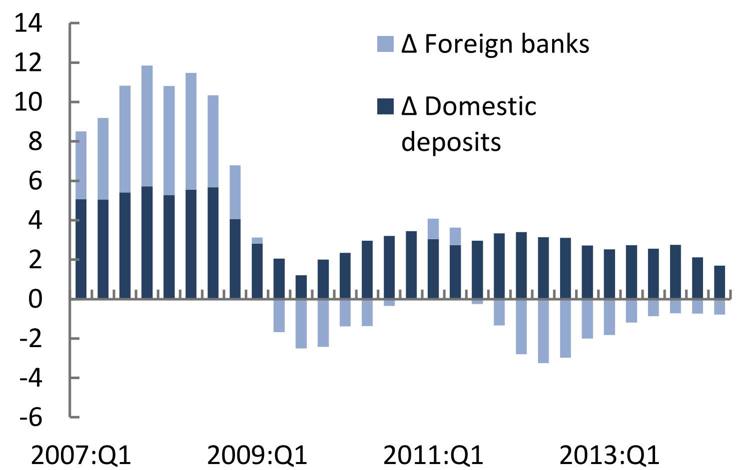
- Banks have been facing deleveraging pressure, deterioration of credit quality, and tighter funding conditions in the post-crisis period. SME lending contracted sharply.
- Evidence, such as the CESEE lending survey, suggests credit flow is constrained from the supply side. Banks' limited capacity of risk-taking contributes to the limited supply of credit to SMEs.

Credit to the private sector, percent change, year-on-year



Note: Nominal, exchange-rate adjusted, GDP-weighted. Source: EBRD and IMF calculations.

Evolution of main bank funding sources in CESEE



Note: Notes: CESEE excl. Russia and Turkey; year-on-year change in the stock of BIS banks' exposure and domestic deposits in percent of GDP, exchange-rate adjusted. Source: EBRD and IMF calculations.

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The role of CGSs as a policy tool

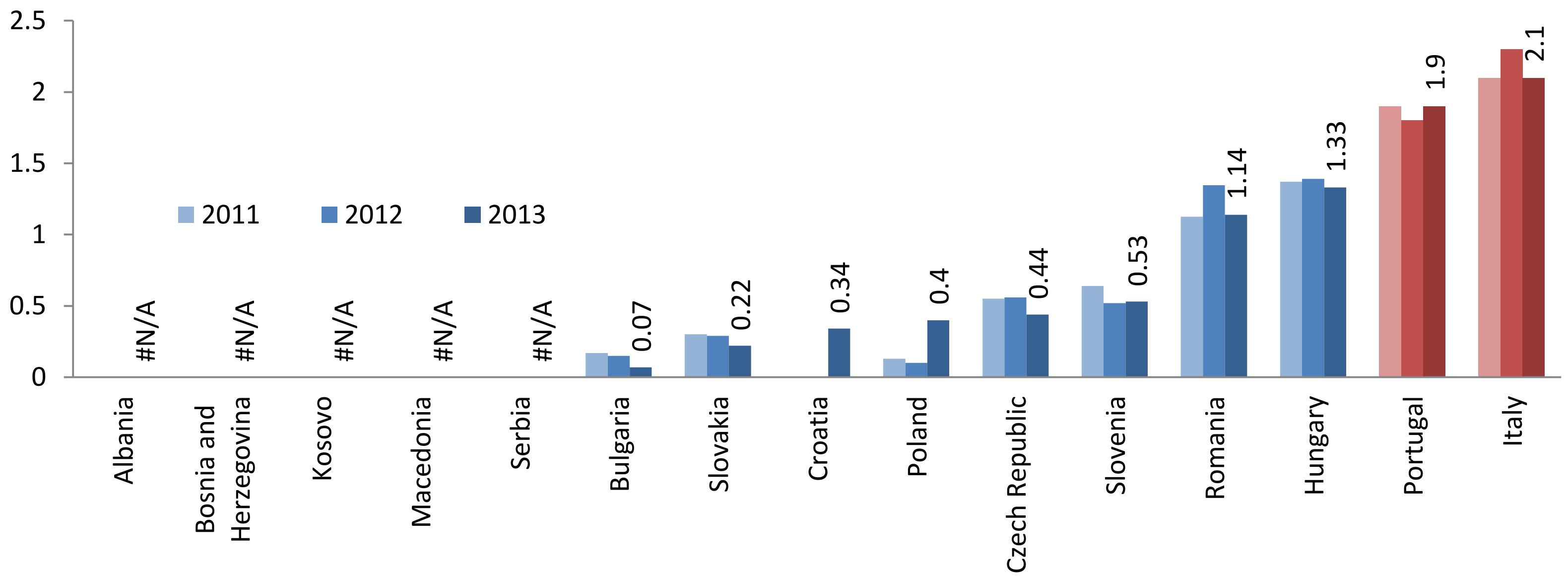
Credit guarantee schemes (CGSs) provide guarantees on loans to borrowers by covering a share of the default risk of the loan. In case of default by the borrower, the lender recovers the value of the guarantee. Guarantees are usually provided against a fee.

- Credit guarantee schemes (CGSs) are used in many countries to **alleviate the constraints facing SMEs in accessing finance**.
- They can play a **catalysing role in emerging economies** where the SME financing gap is generally wider than in developed economies.
- In times of financial downturns CGSs **can be a part of a counter-cyclical public policy toolkit** to support lending to SMEs.
- Although credit guarantee providers can be public or private entities, **public sector involvement is usually judged to be necessary** to supply credit guarantee products in sufficient amounts.

Current CGS activity in CESEE

- CGSs have already been operating in most of the countries in the region.
- Outstanding volumes of guarantees in CESEE range from 1.2-1.3 per cent of GDP in Hungary and Romania to negligible amounts in some non-EU countries of the South-East Europe.

Outstanding guarantee volumes of national schemes by country (%GDP)



Source: AECM

The 'typical' CGS in the CESEE region…

General information	• Established in late 1990s, does not exclusively provide credit guarantees • Publicly owned, legally established as a corporation, and subject to taxation • Capitalized upfront, no explicit restriction on leverage • Non-profit, with an obligation to be self-sustainable • Does not own a banking license, and is regulated by the CB or State
Outreach	• Targets MSMEs, following the EU definition • The primary motivation is to alleviate the lack of collateral and increase lending • Uses guarantees and beneficiaries as indicators, does not monitor job creation/retention, and has never conducted additionality study • Operations increased with the crisis, with no sunset clauses or additional funds
Services	• Offers guarantees to all banks, with borrowers applying directly at banks, where they are informed about the guarantee • Guarantees are for both new and existing loans, and for investment capital, working capital, and leasing • Guarantees are considered on a loan-by-loan basis, and requests are processed in 20-29 days max
Pricing/ Coverage	• Charges only per-loan fees, paid by borrowers • Fees are risk based and payable in advance • Coverage is between 50% and 100% of principal, not interest, for 5 years • Allows lenders to require collateral, which can exceed loan amount • Appraises loans based on the business plan and internal scoring system
Claims	• The trigger is non-payment/ insolvency, with a single payment upon validation • The loss-recovery principle is *pari pas*su, with recovery pursued by the lender • The lender's rights are subrogated after payment
Risk-management	• Counter-guarantees provided by the State • Annual review of pricing policy • No risk concentration

IFI presence: the European Investment Fund

- The European Investment Fund is the key multinational guarantee provider in the region. It provides guarantees to lenders, and also supports the local guarantee institutions with counter-guarantees.
- Besides EIF's own funds, it also manages EU sources, such as Structural and Cohesion Funds as funding for guarantees – a priority usage in the 2014-2020 programming period.

Aggregated maximum portfolio volumes of EIF transactions in the CESEE (June 2014)

Country	EUR mn
Albania:	20
Bosnia - Herzegovina:	20
Bulgaria:	875.4
Croatia:	119.5
Czech Republic:	546.4
Hungary:	522.4
Kosovo:	20
FYRO Macedonia:	15
Montenegro:	20
Poland:	1320.9
Romania:	718.1
Serbia:	16
Slovakia:	501.2
Slovenia:	192.9
CESEE	**4907.8**

Source: EIF

CGSs in the CESEE face a complex and heterogeneous regulatory environment

1. **Credit guarantees in banking regulation:** the key issue is whether and how regulatory capital relief can be obtained for loans covered by guarantees.
   - The CRR provides the legal framework for that within the EU.
2. **Financial supervision and regulation of the CGSs themselves:** significant heterogeneity among national practices within the CESEE
   - Our survey indicates that CGSs are regulated in 6 countries and not regulated in 7 countries.
3. **State aid regulations of the EU:** credit guarantees are included in the EC's definition of state aid.
   - credit guarantees can fall in the scope block exemptions" from state aid rules, such as the *de minimis* regulation, if criteria related to size, sectors, guarantee coverage, maturity etc. are met.

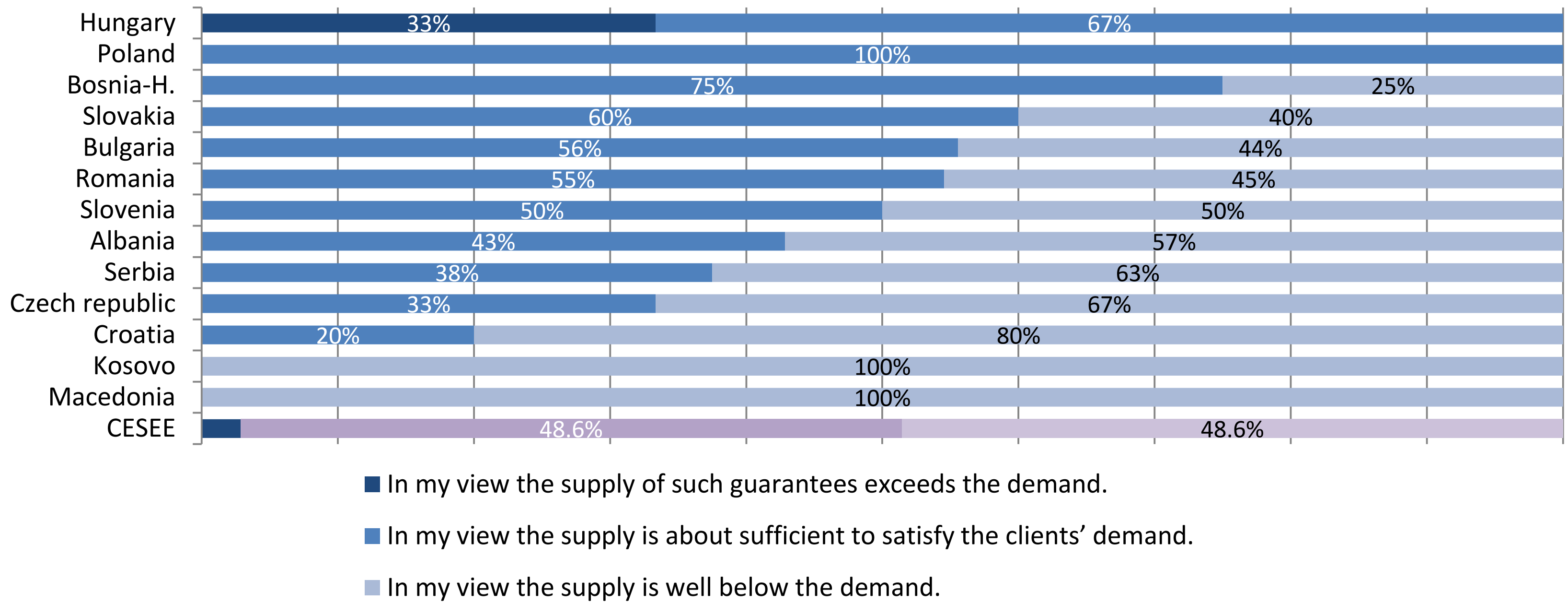
+1. ESA 2010 transition: expected losses from guarantees would be included in government deficit *ex ante* in some cases.

Structure of the presentation

The demand for credit guarantees in the region

- More than 75 percent of CESEE banks have loans guaranteed by CGSs in their portfolios, typically between 1 to 10 per cent of their total SME portfolio.
- About half of the banks believe that the supply of credit guarantees is below demand, whereas another half believes that the supply is about equal to the demand.

Do you believe that the supply of SME credit guarantees is sufficient in your country?

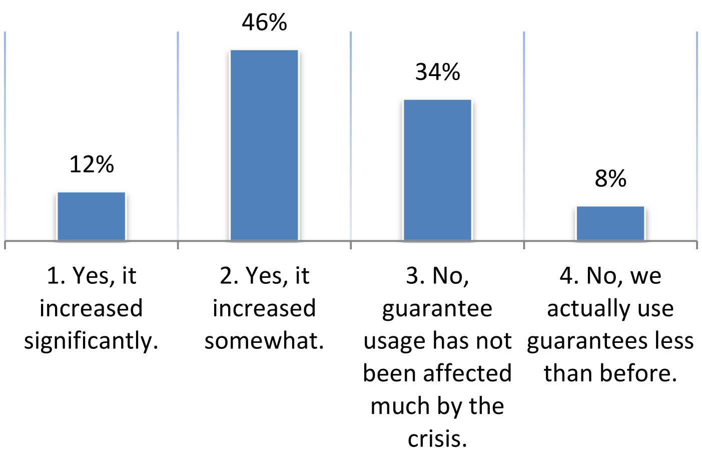


Source: Bank survey

The role of CGSs in alleviating the impact of the crisis

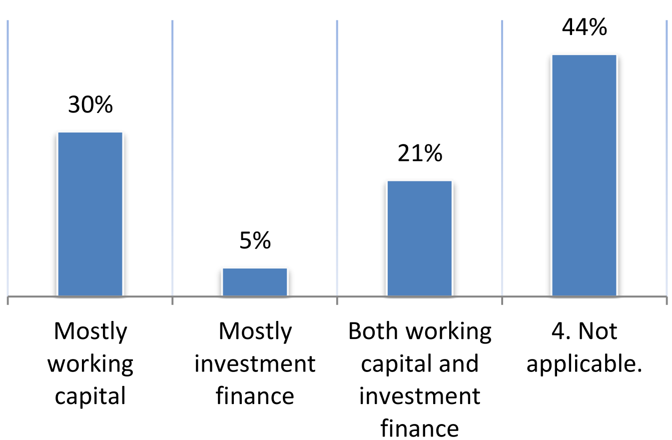
- The CGSs of the CESEE region have reacted to the crisis with various measures. The number of guarantees issued between 2009 and 2012 has increased by 35 percent, while applications increased by 80 per cent.
- The majority of the banks have increased their guarantee usage as a result of the downturn.
- New demand was mainly due to working capital loans, rather than investment.

Does your bank's usage of credit guarantees increased after the crisis?



Source: Bank survey

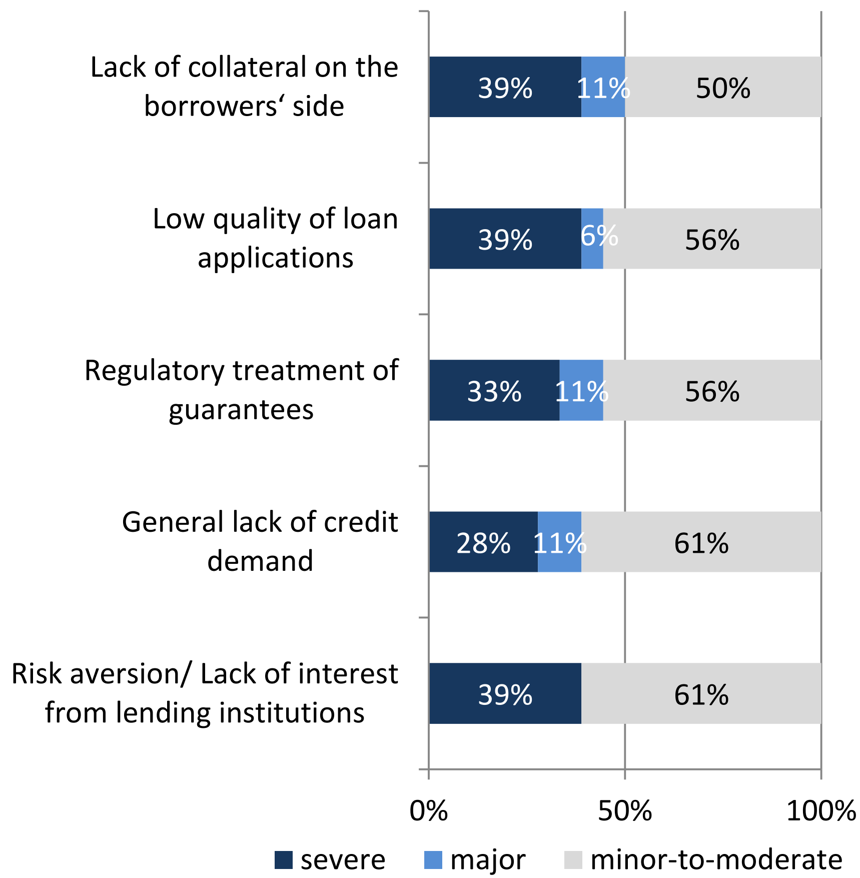
What type of loans contributed to the increase of guarantee use post-crisis?



Source: Bank survey

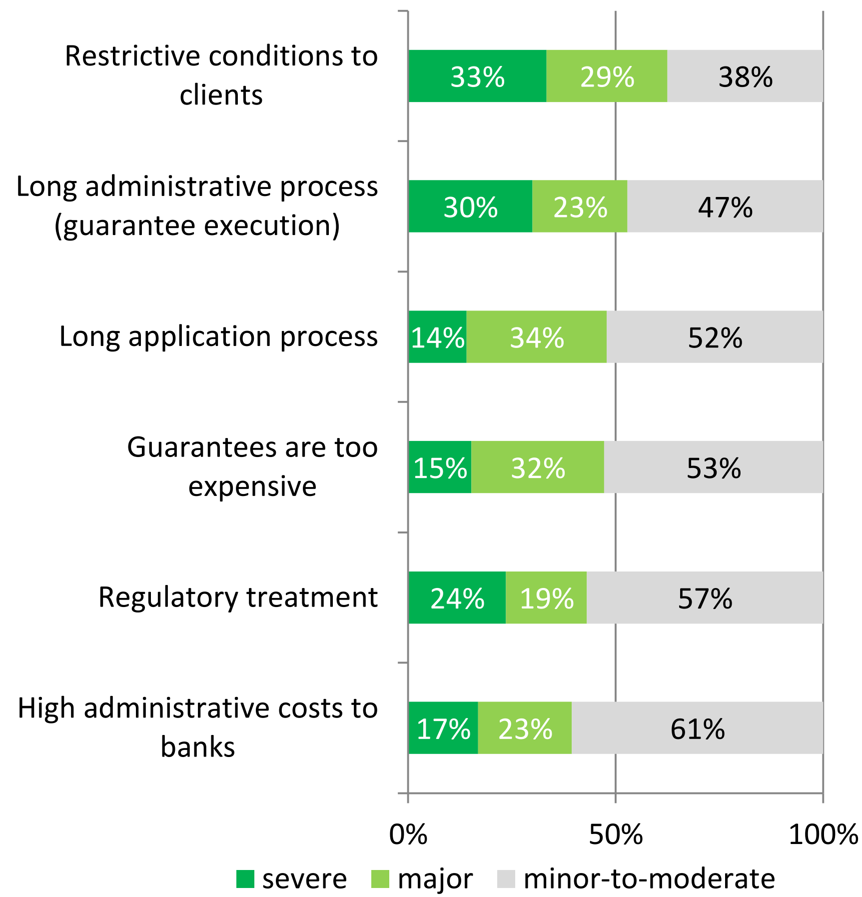
The role of CGSs in alleviating the impact of the crisis

Main constraints identified by CGSs



Source: CGS survey

Main constraints identified by banks

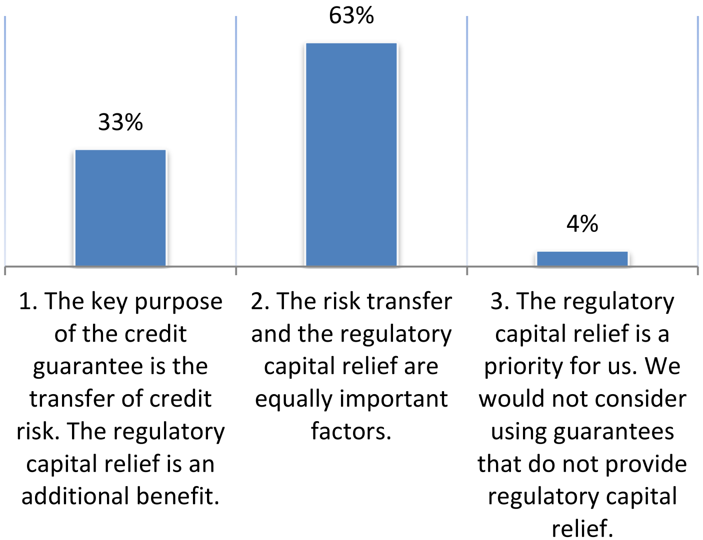


Source: Bank survey

Regulatory issues

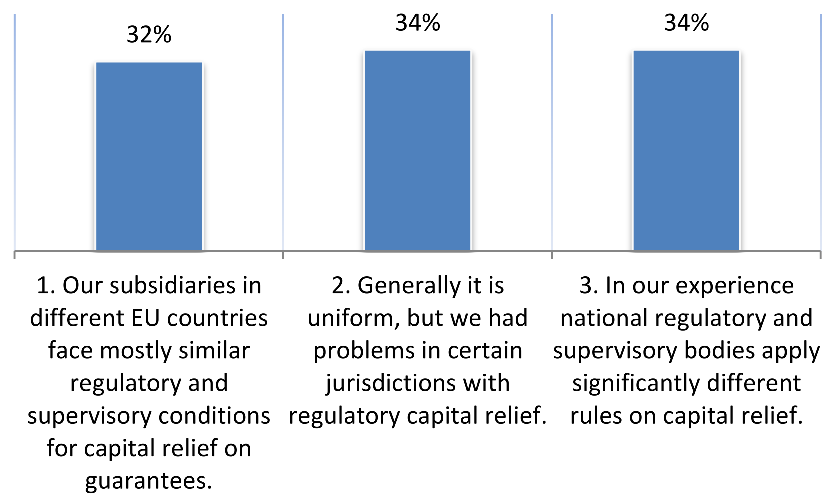
- For banks, obtaining regulatory capital relief on the guaranteed loans is an important component of credit guarantees. More than two-thirds of the banks have been facing problems in this respect at least in certain jurisdictions.
- Low regulatory awareness of CGSs.

How important is it for you to obtain regulatory capital relief for SME credit guarantees?



Source: Bank survey

How uniform is the treatment of guarantees within the EU from the viewpoint of reg. capital relief?

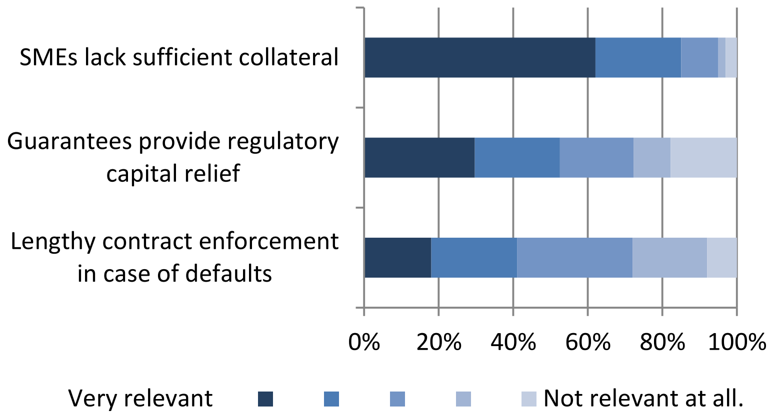


Source: Bank survey

The role of collateral

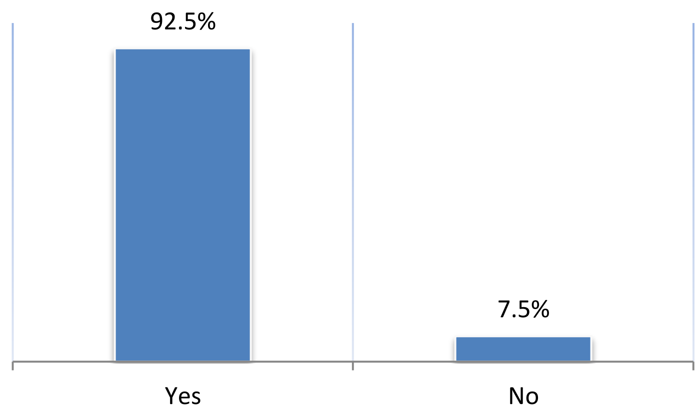
- All 3 surveys confirm that the most important reason to use external guarantees is that their SMEs lack the sufficient collateral.
- Guarantees, however, apparently at best somewhat reduce, but certainly do not significantly eliminate the need for collateral. This calls for an appropriate alignment of incentives in the design of credit guarantees that prevents the crowding out of clients with low collateral.

What are the main reasons for your bank to use external credit guarantees? (Bank survey)



Source: Bank survey

Does your bank usually asks for collateral for loans covered by guarantees for the given guarantor?



Source: Bank survey

Best practices

Best practices for CGSs were identified in the following areas based on the literature covering experiences with CGSs across the globe:

- Mandate and structure.
- Guarantee services.
- Credit appraisal.
- Pricing.
- Loss recovery.
- Financial performance and impact measurement.
- Risk mitigation.
- Regulation.

When assessing their practice against best practices, CGSs in the CESEE have a lot of room to improve.

Measuring economic additionality: the exercise done by the EC and EIF on the MAP SMEG facility is an example to be followed and developed further.

Structure of the presentation

1. The credit guarantee landscape in the CESEE
2. Current issues and challenges
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Conclusions and recommendations – to the public sector & IFIs

1. A strong demand exists for SME credit guarantees in the CESEE region, underlining the need to further develop the infrastructure that provides such products.
2. Credit guarantee schemes can be an effective way to deliver public support for access to finance to SMEs. At the same time public funding is essential for the existence of CGSs in the CESEE, and this support should continue in the future. EU funds and IFIs can play a key role in supporting CGSs in times when fiscal constraints exist at national levels.

Conclusions and recommendations – to CGSs

3. Credit guarantee schemes should be designed and operated so as to ensure the prudent and efficient use of public sources. A number of CGSs operating in the CESEE have room to improve in defining their objectives, measuring performance and additionality, and evaluating long-term sustainability. Smaller, regional guarantee providers may benefit from counter-guarantees, and from a standardisation of their product line.

4. Credit guarantees should allow widening the universe of SMEs that have access to finance, but mechanisms should be in place to limit the “adverse selection” of high-risk borrowers.

5. The ability of credit guarantees to substantially alleviate the need for collateral should be strengthened through appropriate contractual parameters and pricing.

6. CGSs should refrain from excessive administrative requirements and narrow definitions of eligible clients, as these often discourage lenders from the use of credit guarantees.

Conclusions and recommendations – to regulators and banks

7. For EU countries, uniform treatment of the regulatory capital relief for credit guarantees by national authorities may facilitate the more widespread use of these instruments.
8. A coherent approach to, and a stronger awareness of credit guarantee schemes by the national financial regulatory and supervisory authorities is desirable.
9. Banks could support the use of credit guarantees by ensuring that loan officers are provided with the necessary incentives to roll out guaranteed loans.

Concrete actions

Already taken:

- The WG initiated the issuance of a guideline (Q&A) by the European Banking Authority (EBA) to clarify conditions of regulatory capital relief.
- Workshop with regulators, endorsed by EBA, on guarantee schemes.
- Some banks have used the momentum of the study to re-evaluate their internal, group-level approach towards CGSs.

In the pipeline/to be considered:

- Increase IFIs' role in funding of CGSs, substituting for sovereign funding in times of fiscal constraints.
- Promoting the study towards local CGSs with the help of AECM – closing the gap between actual and best practices, and strengthen the products to better address the collateral problem.
- Promoting the study to banks operating in CESEE to raise their awareness of CGSs.