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Mutual Guarantees in SME Financing

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Strength of Guarantee schemes:

Source AECM

Intermediary between SMEs, lenders and Public authorities
Based on consensus, added value and shared responsibility

Lender

Mutual Guarantee Scheme

SME customer

Public Authorities

Experience: 70 schemes operating in 1995

Need co-operative relationships between guarantor and lenders

Guarantee for Capital or Interest and Capital?

Criteria: eligibility, leverage, risk sharing, fees and claims procedures.

Define roles and responsibilities of lenders + guarantors

Need monitoring by guarantors of lending institutions

Precise procedures for guarantee approvals and claims

Levitsky, 1997

Mutual Guarantees in Europe

34 active schemes in 18 EU countries
Key figures (31.12.2007, in €m)

– SMEs Own Funds € 6.125

– Guarantees issued in 2007 € 23.972

– Outstanding commitments € 55.423

Leverage Cap / commitments > 10 x

– SMEs beneficiaries > 1,7 Million

Source: AECM, Brussels, 2009

Guarantee fees

Paid by bank -> Passed on to borrower

Based on total loan or just the guarantee proportion?

Registration fee for the processing of a guarantee application? (typically 0.25-1 per cent of the loan)

Annual fee on the amount covered? (typically 0.5-2 per cent of the guarantee amount)?

Additionality: 50 to 85% seems possible

Sustainability: In advanced economies – losses ranged from 5% to 15%

Source: Levitsky, 1997

In summary CGS can provide:

5 to 10 X leverage, and meet all claims (Germany, France and Italy, 20+ X) Source: Graham Bannock, 1995-7.

With appropriate screening by lenders and guarantors + effective portfolio management + debt collection:

CGS SME loan portfolios can have default rate of < 5%

Few banks, good market coverage and high volumes……

Improve financial + economic impact + sustainability.

Loss rates may be high (2 to 3% normal, 5% acceptable)

Could still be cheaper than grants or subsidies!

Against CGSs? ‘Moral Hazard'

CGSs may weaken the commitment of borrowers to repay

Lending bank may have less incentive to supervise the loan and pursue vigorously the collection of repayments.

More of a danger in theory than practice because…..?

Risk to Banks’ reputations
SME borrowers – need continued access to credit

But issues of…additionality and sustainability?

Credit guarantee schemes for SMEs an international review
JACOB LEVITSKY, *Small Enterprise Development Vol8, June 97 No 2, pp 4-17*

Credit guarantees cannot respond to all needs of SMEs:

But many believe that CGSs are the *most economic use of funds in financial* support for SMEs.

Operate best in a liberalized financial sector where banks compete for clients.

In time, increasing amounts of decision-making can be transferred to the accredited financial institutions.

But, CGS should be subject to limited regulation.

CGSs are long-term; require adequate resources and time to build up the trust of the financial institutions.

Source: Levitsky, 1997

Commission Communication 'Implementing the Community Lisbon Programme: Financing SME Growth – Adding European Value' COM(2006) 349 final.

"….publicly-backed loan guarantees can lower the risk of bank lending, and have a large effect on lending to SMEs.

Guarantees can have a countercyclical effect by helping to maintain banks' lending volumes."

Quoted from: Cyclicality of SME finance: Literature survey, data analysis and econometric analysis; EIM / European Commission: May 2009

Questions and discussion?

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Through the Competitiveness and Innovation Programme 2007-2013 (CIP), the European Investment Fund (EIF) manages various instruments….., including:

− The SME Guarantee Facility,

loan guarantees to encourage banks

more debt finance available to SMEs,

including microcredit and mezzanine finance,

by reducing the banks' exposure to risk;

E.G. Requirements for a guarantee payout:

1. arrears and non-payment of loans for 90 (or 120) days;

2. contacted defaulters + sent out warning notices on time;

3. called in total loan after time has lapsed and warnings given and ignored;

4 .the loan being written off in the accounts of the lending institution; and

5. the initiation of legal steps to foreclose on any collateral and for the recovery of the loan.

Source: Levitsky, 1997

Guarantee scheme staffing:

1. review, assess + approve applications for guarantees;

2. to review regular reports on numbers of applications and situation of the portfolio of guaranteed loans;

3. to process / review claims for payment of guarantees;

4. for recovery from defaulters, after guarantees paid out

5. maintain records of guarantees and claims; report on effectiveness of the system and forecast trends;

6. to advise borrowers with loan guarantees who are facing difficulties (in some schemes).

Source: Levitsky, 1997