EBRD coronavirus policy response

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State credit guarantee schemes: Supporting SME access to finance amid the Covid-19 crisis

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Overview

The Covid-19 pandemic has reduced the funding of many firms, especially small and medium enterprises (SMEs). In response, a number of countries in both Western Europe and the EBRD regions have scaled up state credit guarantee schemes to mitigate this urgent liquidity problem and stimulate an economic recovery. This note highlights the design and implementation aspects of these schemes. It suggests that this instrument, if well designed and implemented, can be an efficient crisis response mechanism, as it relies on the banking sector to channel financing to firms, while safeguarding the soundness of the banking sector by partly assuming the risk of on-lending.

What are state credit guarantee schemes?

State credit guarantee schemes (SCGSs) provide guarantees for banks' on-lending, mainly to SMEs. Their purpose is to cover a part of any bank loss incurred when a borrower defaults on a loan. By having the state guarantee, for which the lender usually pays a fee, the risk (and the potential loss) is shared between the lender and the state. This encourages lending by the banks. In 'normal' times, the schemes mostly target relatively unserved market segments, such as young firms with limited or non-existent credit histories. Such schemes are all the more important in times of economic downturn, when banks are typically reluctant to lend, even to sound and viable firms, thus jeopardising the recovery potential of the economy.

Implementation of SCGSs is mostly done through banks. In many cases, governments will use existing development banks, which will leverage the credit appraisal infrastructure of partner commercial banks willing to participate in the scheme. Guaranteeing bank loans also expands the types of lending products offered, ranging from working capital to investment loans. After lending institutions complete their appraisal, they usually need to request further approval from the "guarantor" (i.e., the state).

Use of these schemes also carries risks. Previous studies show that SCGSs can increase default (or at least less timely repayment) among borrowers.[1] These risks are higher in countries where firms are in need of liquidity but are already highly indebted.[2] In addition, successful implementation of this policy instrument depends on the health of the banking sector, as well as on the sustainability of the public finances, as it creates contingent liabilities for the government.

[1] See C. Lelarge, D. Sraer, and D. Thesmar (2010).
[2] See C. Bircan et al. (2020).

How have SCGSs been used during the Covid-19 crisis?

Many firms, especially SMEs, are facing unprecedented liquidity strains. Given their advantages and notwithstanding the risks, SCGSs have emerged as a potentially effective policy tool for addressing the liquidity gap. The mechanism is attractive for its quick deployment (where already in place) and low immediate budgetary implications, especially when compared with other tools such as subsidised lending and grants.[3] As such, SCGSs have been one of the most widely used instruments both during the global financial crisis more than a decade ago and now during the Covid-19 economic crisis. Almost two-thirds of EBRD countries of operations are implementing or expanding this policy instrument.

Developed countries have used SCGSs extensively as part of their Covid-19 crisis response package. For example, the German development bank, KfW, has devised two guarantee schemes covering EUR 400 billion (around 12 per cent of GDP) of loans to support lending to SMEs and large firms.[4] The coverage amounts to up to 90 per cent of the loan for SMEs (and up to 80 per cent for large firms) and full coverage of loans up to EUR 500,000 for small enterprises. The two schemes also allow a grace period of two years for loan maturities of up to ten years. The French authorities also announced a similar guarantee scheme worth EUR 300 billion (around 12 per cent of GDP) covering up to 90 per cent of the loan principal for firms employing up to 5,000 people and up to 80 per cent for firms with revenue between EUR 1.5 billion and EUR 5 billion.

Within the EBRD regions, significant differences exist in terms of resources for guarantee schemes. Countries that have announced guarantee schemes are mostly those with already existing institutional infrastructure, including national development banks and SCGSs already in place. These countries are mostly in the central and south-eastern Europe, such as Poland, which mobilised the largest funding for this policy instrument among all EBRD countries (see Box 1). Outside the EU, countries that have been able to leverage existing instruments in this area include Turkey, Georgia and Jordan. By expanding the existing schemes, these countries have been able to swiftly step up their support through this mechanism. Other countries, including Albania, Bosnia & Herzegovina (the Federation of Bosnia and Herzegovina), Moldova and Serbia, have announced the intention to set up, or are considering, SCGSs as a policy response.

Box 1. Poland state credit guarantee scheme response

Poland has devised one of the most comprehensive responses in terms of guarantee schemes, leveraging it on other financial instruments, worth a combined EUR 45 billion (8.5 per cent of GDP).

First, a guarantee scheme run by the Polish Development Bank (BGK), the Liquidity Guarantee Fund (LGF), worth EUR 22 billion, secures up to 80 per cent of a loan's principal. The scheme focuses on medium-sized firms, defined as those that employ at least 50 people or have a yearly turnover of at least EUR 10 million. The loan size must be at least PLN 3.5 million (ca. EUR 785,000), or double the annual payroll expense, or 25 per cent of the 2019 turnover. The commission fee on such guarantees is removed (previously at 0.5 per cent), while the interest rate in the first year is set at 25 basis points (bps) and at 55 bps in the second. In line with the EC's guidelines, the scheme will be available until the end of the year. Loans can have a maturity of up to six years. By late-May, 8,700 companies received credit guarantees since early April, when the scheme was approved by the EC. The BGK has also offered support to small enterprises through its existing *de minimis* credit guarantee scheme, originally rolled out in the previous financial crisis on terms similar to the LGF.

The Polish Development Fund runs the second scheme, called the PFR Liquidity Shield, worth another EUR 22 billion. The fund provides loans, factoring arrangements and guarantees, supporting firms of all sizes with liquidity instruments available in the next two years, with a maturity of up to three years. The offered support is limited to PLN 1 billion. The funds cannot be used to finance stock buybacks, M&A activity, or refinancing of existing liabilities. As of late-May, 150,000 companies had taken advantage of the scheme.

The funding for the two schemes is done through issuance of bonds by the two institutions, which are eligible to be acquired by the National Bank of Poland under its QE programme. A setup with the central bank being an important buyer of these bonds may not be universally applicable in countries with lower monetary credibility or a more rigid exchange rate regime.

How do SCGSs differ in design and implementation?

Eligibility in most schemes is contingent on firm's financial soundness prior to the crisis. This helps limit the exposure of banks and governments to potential defaults. Additional requirements and restrictions are usually present: in Lithuania for example, support is not granted to firms operating in gambling, ammunition, tobacco and alcohol production and sales. In Bulgaria, firms must prove a decrease in revenue, reductions in employees, or closed production facilities. In Turkey support is contingent on the firm not cutting employment registered prior to the pandemic.

[3] See M. Chatzouz et al. (2017).
[4] All SCGS values refer to the loan amounts that the state covers through guarantee schemes.

Guarantees coverage ranges from 50 per cent to 100 per cent of the loan principal. Those schemes based on the European Commission's guidelines cover up to 80 per cent of the loan for SMEs, with the ratio increased to 90 per cent in Romania, and even 100 per cent for micro enterprises in Estonia. In Azerbaijan, the SCGS covers 60 per cent, while in Greece and Latvia the announced guarantees cover up to 50 per cent of the loan. The comparatively lower coverage ratio may be explained by the subsidised and soft lending schemes that are provided in parallel in these countries.

Loan conditions in most SCGSs include limited maturities, lower or subsidised interest rates and grace periods. Given loan ceilings, guaranteed credit usually has a grace period for re-payments, ranging from six months in Turkey to three years in Bulgaria, with most of the schemes offering payment holidays for 2020. Interest rates are usually decided by banks but in some cases are limited by design. For instance, in Slovenia, the interest rate increases gradually during each year, while in Azerbaijan the state subsidises 50 per cent of the interest rate. In Romania, the government also subsidises all interest expenses in 2020. In terms of maturity, loans are usually granted for an average period of around three years. In addition, some SCGS provide even further benefits for investment loans compared to working capital credit (e.g. in Latvia, Romania). Guarantee premiums, or the cost for using the scheme, are minimised in most cases, or even set to zero, emphasising the non-profit character of SCGSs during this period.

Subsidised lending was in some countries deployed as a substitute to SCGSs, while in others as a complementary mechanism. In Croatia, for example, the authorities have used the national development bank, HBOR, to provide soft liquidity loans, under an EC-approved scheme, to affected firms. This is also the case in Hungary, where a grant component has been included, while in the Baltic States, where development banks also implemented direct lending instruments, SCGSs are seen as complementary.

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