Analysis

Credit Guarantee Programs for Small and Medium-Sized Enterprises

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Original post here.

With the economic fallout from the coronavirus pandemic likely to have a particularly significant impact on small and medium-sized enterprises (SMEs), countries around the world have adopted or are considering measures intended to support such businesses. One common tool for doing so, even in non-crisis times, is an SME credit guarantee, a program pursuant to which governments encourage banks to lend to SMEs by at least partially guaranteeing those loans. While evaluations of these programs are somewhat limited and the evidence mixed, when an event like the Asian Financial Crisis or the Global Financial Crisis occurs, countries often expand existing SME credit guarantee programs to make them more responsive to crisis conditions and/or develop new programs specifically targeted to the crisis.

When designing an SME credit guarantee program, the following four categories of design decisions are of particular importance to policymakers:

1. Underwriting - who will be responsible for approving the guaranteed loans?
2. Risk sharing - how much of the loans will be guaranteed?
3. Fees - how much will borrowers have to pay in guarantee fees?
4. Eligibility - what borrowers will be eligible to participate and what type of loans will they be able to receive?

Below is a summary of how policymakers have approached these questions in the past.

Underwriting

Typically, the decision to extend particular loans has been made by the banks themselves, often with the rationale that they are better positioned to engage in credit analysis than the government. This decision is closely tied to how risk sharing is structured. If the banks are determining which borrowers get loans, fully guaranteed loans could give rise to a moral hazard problem because the banks won't suffer any losses from non-performing loans.

Less frequently, governments have decided which loans to extend. Japan's Special Credit Guarantee Program (SCGP), adopted in 1998 during its banking crisis, involved the government making underwriting decisions (while also providing a full guarantee). In its screening process for borrowers, it relied on a short list of negative characteristics such as tax delinquencies and previous bank loan defaults. The SCGP typically accepted any borrower not possessing one of the listed characteristics, with the result that the approval rate was very high. However, this limited credit analysis has been criticized as having contributed to misuse by borrowers. Government involvement in underwriting may also result in high program administrative costs, as appears to have been the case with South Korea's Credit Guarantee Fund.

Risk Sharing

As noted above, the question of how much of a loan should be guaranteed introduces the issue of moral hazard. For that reason, SME credit guarantee programs have typically provided partial guarantees (often in the range of 70%-80%). This leaves banks with some of the loss associated with a non-performing loan and therefore offers better incentives to conduct effective credit analysis. The portion guaranteed is not always fixed. In the Czech Republic, the Czech-Moravian Guarantee and Development Bank provides a gradual guarantee whose percentage increases over the duration of the loan up to a cap of 80%.

Some countries have sought to preserve these incentives while still fully guaranteeing loans, particularly in times of crisis. In Thailand, the Thai Credit Guarantee Corporation established during the Global Financial Crisis provided a full guarantee, but only if a participating bank's portfolio of guaranteed loans did not have non-performing loans that exceeded 16% of the total.

Chile's FOGAPE takes a unique approach to risk sharing, determining the percentage of a loan to be guaranteed pursuant to an auction in which banks bid for the right to provide a certain amount of guaranteed loans. Bids with the lowest guarantee percentages are selected first until the total amount of guarantee rights has been allocated. Such an approach may be consistent with research by Yoshino and Taghizadeh-Hesary (2016) arguing that guarantee percentages should vary by bank based on soundness (and based on macroeconomic conditions).

Fees

In determining the guarantee fees to be charged in connection with an SME credit guarantee program, countries typically seek to balance the desire to fund the programs with the need to avoid pricing out participants. Flat fees of approximately 1% to 2% of loan amounts seem common. A reduction in such fees is often a way that existing programs are adapted in the face of crisis.

Eligibility

SME credit guarantee programs can either be broadly available or, less commonly, limited to borrowers meeting specific criteria. In the UK, the Enterprise Finance Guarantee adopted during the Global Financial Crisis required borrowers to demonstrate that they had first been denied a loan outside of the program. Programs in the US, Brazil, and Turkey had similar features. The Greek Credit Guarantee Fund of Small and Very Small Enterprises (TEMPME SA) limited participation to firms that had been profitable over the previous three years. In Italy and Chile, rather than acting directly, programs have provided guarantees to mutual guarantee associations that in turn provide guarantees to their SME members.

What types of loans will be eligible is also an important consideration. To ensure that guaranteed loans are not used to refinance existing non-guaranteed loans, many programs contain a prohibition on this practice. Programs often specifically include shorter-term working capital loans. In Canada, a Global Financial Crisis-era initiative called the Canada Small Business Financing Program excluded working capital loans despite a subsequent survey that showed over half of all SMEs intended to use debt financing for that purpose. This exclusion was seen as limiting the program's effectiveness.