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EUROPEAN ASSOCIATION OF MUTUAL GUARANTEE SOCIETIES

Growing together

**Pricing Survey:  
Global results**

**August 2012**



## **PRICING OF GUARANTEES: GLOBAL RESULTS**

Foreword

AECM – the European Association of Mutual Guarantee Societies – has currently 38 Members operating in 20 EU-Member States, Turkey Montenegro and Russia. Its members are mutual, private sector guarantee schemes as well as public institutions, which are either guarantee funds or development banks with a guarantee division. They all share the mission of providing loan guarantees for SMEs who have an economically sound project but cannot provide sufficient bankable collateral.

AECM is primarily a trade association whose core activity is defending the interests of its members towards European and international authorities. This is essential for its members. For the Association's lobbying activity to be effective and trustworthy, it has to be based on reliable statistical data. Such data should serve as first-hand material to conduct specific research.

To this end, a Statistics Working Group (WGS) has been created within AECM. One of its first study projects was to assess "How AECM members price their guarantees", which it is of particular importance. Indeed, it is key for guarantee schemes that guarantee premiums are set appropriately, taking into account different parameters and criteria allowing the scheme to function sustainably, all the while being careful to keep providing an incentive to facilitate SMEs access to loans.

This study follows a first general survey conducted by AECM on its member organizations in 2003, which for the first time presented an inventory of the different guarantee systems around Europe. The aim of this document is to go into more specific technical detail on a selected issue.

All those - and in particular the AECM secretariat - who contributed to the drafting of the study are gratefully acknowledged.

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To this document is  
annexed the

Pricing survey:  
AECM Members'  
description



## **Introduction**

Pricing is an important topic for Guarantee Societies, because it has to be in an appropriate range: not too high, otherwise it might discourage the use of guarantees, and not too low, to avoid for instance the unnecessary use of guarantees for loans which are sufficiently collateralized and could normally be granted by banks without the presence of a guarantee (private or public). In this case, a very low guarantee premium could become a commercial argument for banks to soften their requests towards their clients.

The design of the premium level is variable and depends either on the application of the principle of mutualism or on the direct or indirect recourse to public funds. In any case, the pricing has to reflect the general economic environment and specific circumstances under which respective national guarantee schemes have been set up and operate. When a guarantee scheme is integrated in an institution providing different support instruments, such as loans or grants, there can be synergy effects on the pricing. Indeed, transaction costs can be lowered if the risk analysis is done in order to offer several products at the same time; a guarantee application resulting from an internal request within the institution can also create privileged premium conditions, resulting from a better transparency.

## **Methodology**

AECM has carried out a survey among its members on the pricing of their guarantee products. Different features have been assessed, namely the basis and the computation of the guarantee

premium, the different terms of payment and examples.

In particular, we assessed the following crucial aspects regarding pricing models of AECM members:

1. **The calculation basis of the guarantee premium**
2. **The effective calculation of the guarantee premium**
3. **The charging method of the guarantee premium**
4. **Additional administrative or managing premiums charged on top of the guarantee premium**
5. **The different pricing policies**

This survey does not aim at identifying best practices or set up benchmarks. Pricing is influenced by many factors which cannot be taken fully into account, because of the limited scope of this study. Pricing diversity provides evidence that in similar situations presenting some common features, alternative approaches can be used in setting up a pricing model.

While drafting the survey, it became clear that the definitions used by the respondents concerning the duration of guarantee commitments was essential to assess the different pricing schemes. A complementary questionnaire was sent out to the respondents for this purpose.

## **Findings**

AECM has received 30 answers for 38 of its member organisations, as well as 15 pricing grids.





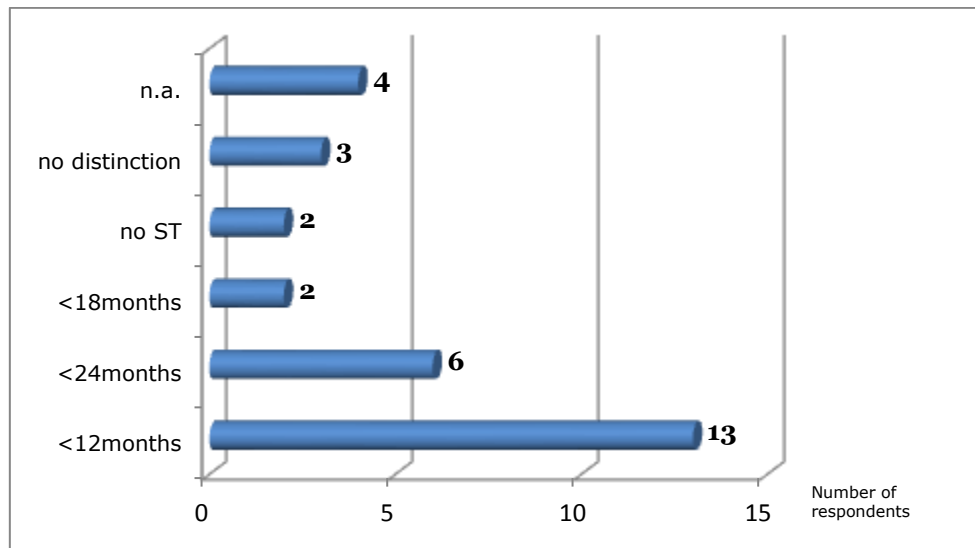
## 1. MATURITIES OF GUARANTEE COMMITMENTS

As a first step, it was necessary to present the underlying definitions used by AECM members for the different maturities, i.e. short, medium and long term. The following two charts show the variety of different definitions of maturities of

guarantee commitments used by AECM members who have taken part in the survey.

The first graph illustrates the different maturities applied to short term commitments and states the effective numbers of respondents.

- a) Maturities of short term commitments – Guarantee duration for short term loans: (in effective numbers)

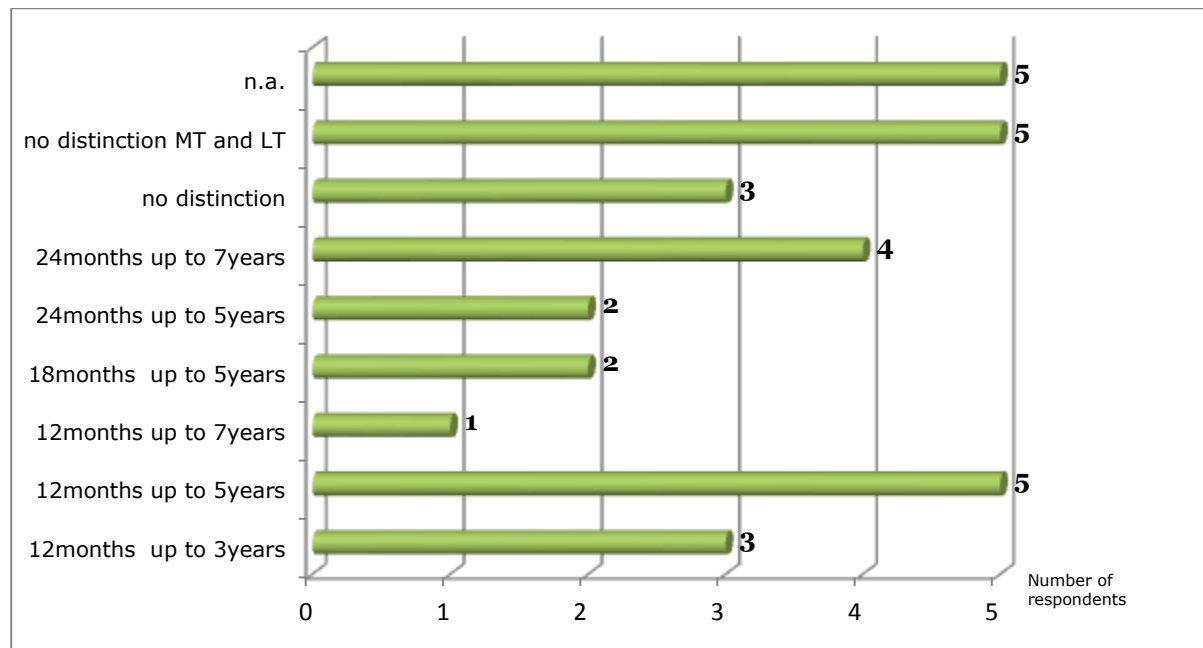


Among the respondents accounting for short term maturities, the majority (13) consider short term commitment as  $\leq 12$  months. 8 respondents consider either 18 months or 24 months as the maximum short term duration. 9 respondents either do not distinguish short term maturities in

their portfolio, do not provide guarantees for short term or did not answer.

The graph on the next page specifies the medium term definition used by the respondents.

b) Maturities of medium term commitments – Guarantee duration for medium term loans: (in effective numbers)



There is no uniform picture emerging from the definition of the medium term and the long term durations. It is striking that nearly half (13) of the respondents do not distinguish the medium term from the other maturities (8), or do not provide an

answer. Among those who have a definition for the medium term, 53% (9) set 5 years as the upper limit, followed by 18% who apply 3 years as an upper threshold.

## 2. CALCULATION BASIS FOR THE GUARANTEE PREMIUM

The calculation basis is a determining feature in order to establish the guarantee premium. Great differences in the premium level will result depending on the basis chosen. The choice of

the calculation basis will also vary according to the underlying maturity, distinguishing between short term loans on onside and medium to long term loans on the other.

### a) For guarantees on short term commitments - Overdrafts:

Typically, overdrafts and working capital loans are issued as credit line. While this line comes with a maximum amount, the customer will draw according to his operational needs, e.g. for financing inventory, etc. and repay flexibly in a similar way. Therefore, the extent to which the line is effectively used can be very variable over the length of the commitment. Similarly, the guaranteed amount, as a percentage of the funds effectively drawn, will also be variable over time.

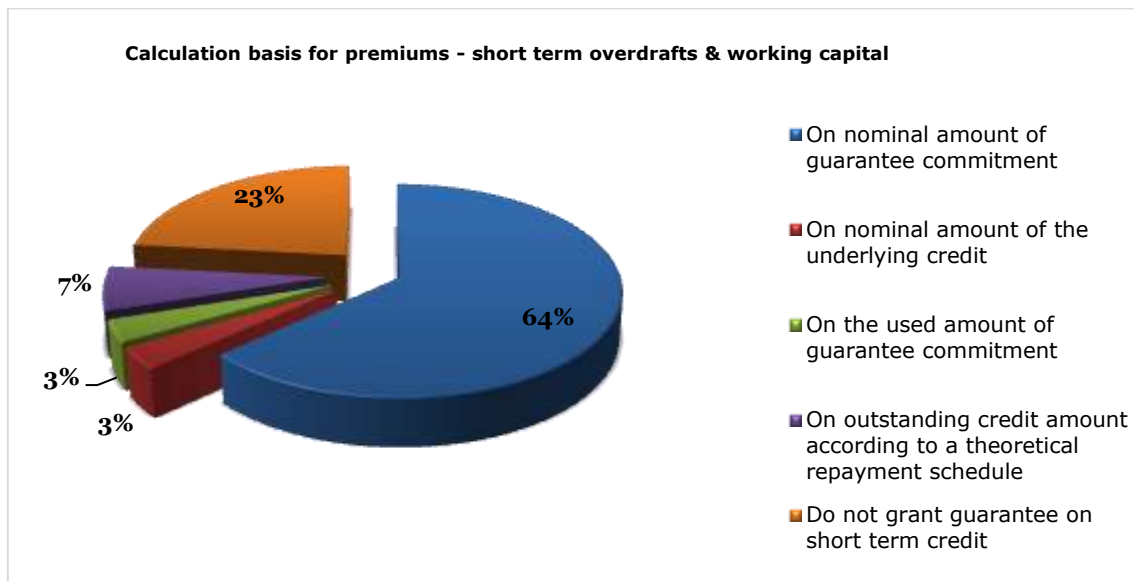
Among the respondents, 77% grant guarantees for short term credit in the form of overdrafts, working capital loans, etc.

We have found that the great majority of the respondents (64%) use the guarantee's nominal amount (which represents a fixed percentage of the underlying credit). This choice, is related to the fact that for overdrafts and credit lines, the use of the credit volume can be variable, over time, as mentioned above and therefore difficult to track. The nominal guarantee amount in turn is known, it represents the maximum commitment and risk exposure for the guarantee institution

under the individual operation. Consequently, this method offers the advantage of reducing management / administrative costs, as it allows avoiding the precise follow up of actual use of the short term facility. Also, basing the premium on the maximum risk exposure is legitimate from a risk management point of view, as a borrower getting into difficulties will normally use the full amount of its authorized overdraft before bankruptcy.

While the use of the nominal amount of the guarantee as a calculation basis is the predominant model, it has to be signalled that some alternative methods are practiced by some members:

- 1 respondent uses the nominal amount of the underlying credit
- 1 respondent applies the used amount of the guarantee's commitment
- 2 respondents use the outstanding credit amount according to a theoretical repayment schedule.



b) For guarantees on short term commitments – Redeemable<sup>1</sup> loans:

Redeemable short term loans present a different situation as compared to overdrafts and working capital loans, as they are granted for a determined loan amount and either repaid in one sum or repaid according to a repayment schedule.

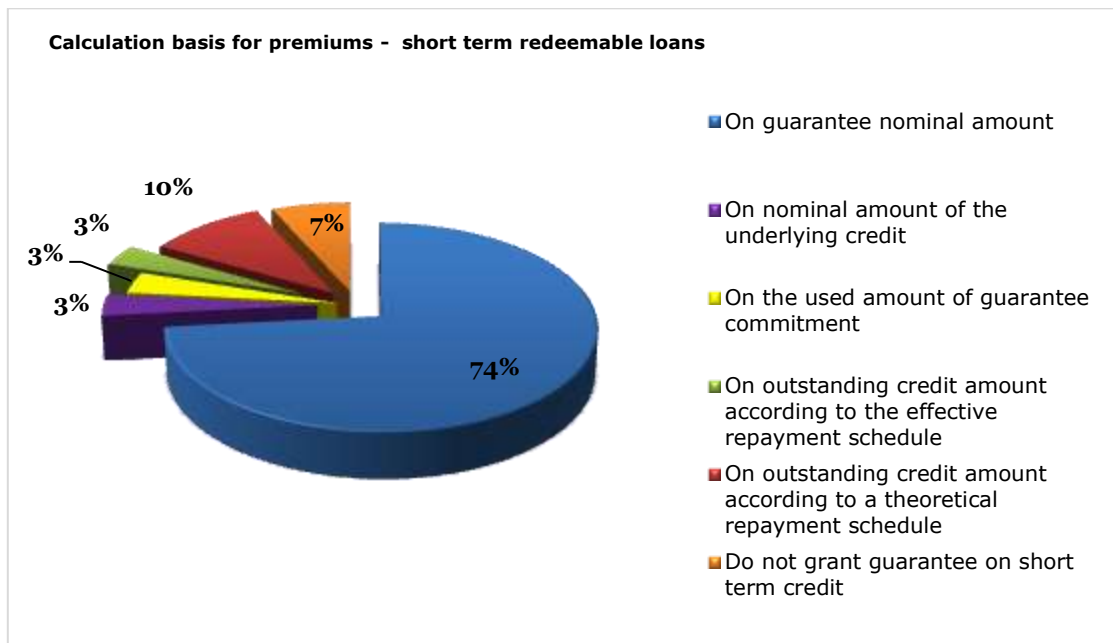
Significantly more respondents grant guarantees for short term redeemable loans (93%) than for overdrafts (77%).

Again, as for overdrafts, the preferred choice of calculation basis is the nominal amount of the guarantee commitment (74% of answers). Another 3 % base the calculation of the premium on the outstanding amount of the guarantee's commitment (this is applicable in case of a repayment of the loan by instalments).

In contrast to overdraft guarantees, in this case a few more members use the credit amount as a calculation basis:

- 1 respondent uses the nominal amount of the underlying credit
- 3 respondents use the outstanding credit amount of the according to a theoretical repayment schedule
- 1 respondent uses the outstanding credit amount according to the effective repayment schedule

<sup>1</sup> Redeemable: for short term credit "redeemable" means investment loans on a short maturity for which the principal is paid back according to a fixed schedule

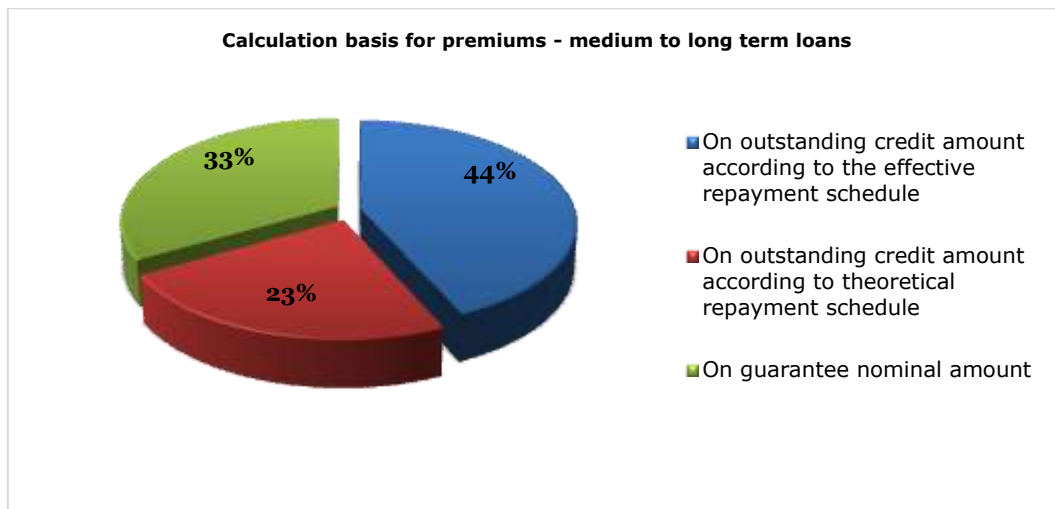


c) For guarantees on medium to long term investment loans:

Medium to long term loans are mainly granted for investment projects. The loan amount is typically fully drawn and repaid according to an established repayment schedule. The guarantee amount will decrease over time in proportion with the loan amount, as the latter is progressively repaid.

For this type of loan guarantee, there are different options for a calculation basis:

- The guarantee premium can be established on the basis of the guarantee amount (established as a percentage of the outstanding amount of the underlying credit) according to **the effective** repayment schedule. This option is the most commonly chosen procedure (44 % of the respondents).
- Another variant of this method is the use of the guarantee amount (established as a percentage of the outstanding amount of the underlying credit) according to **a theoretical** repayment schedule (23 % of the respondents). This latter option allows avoiding management costs related to a detailed follow up. It has to be kept in mind that the difference in the amount of liability between effective and theoretical schedule is often very small.
- However, 33 % of the respondents use the **guarantee nominal amount**, as is the case for short term loans.



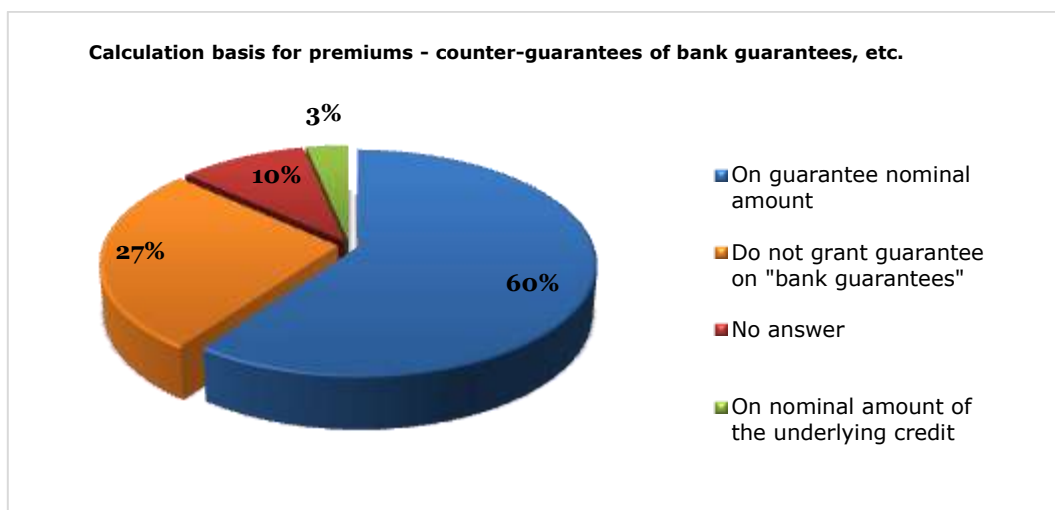
d) For counter-guarantees issued by Guarantee Societies to secure bank guarantees or bonds:

In some cases, aside from bank loan guarantees, guarantee institutions can also issue other types of guarantees, e.g. counter-guarantees for a guarantee by a bank, performance bonds, etc.

One respondent uses the nominal amount of the underlying credit.

The remaining 37 % of the respondents do not issue such guarantees or did not answer.

For this type of operations, the vast majority of the respondents (60%) use the guarantee's nominal amount

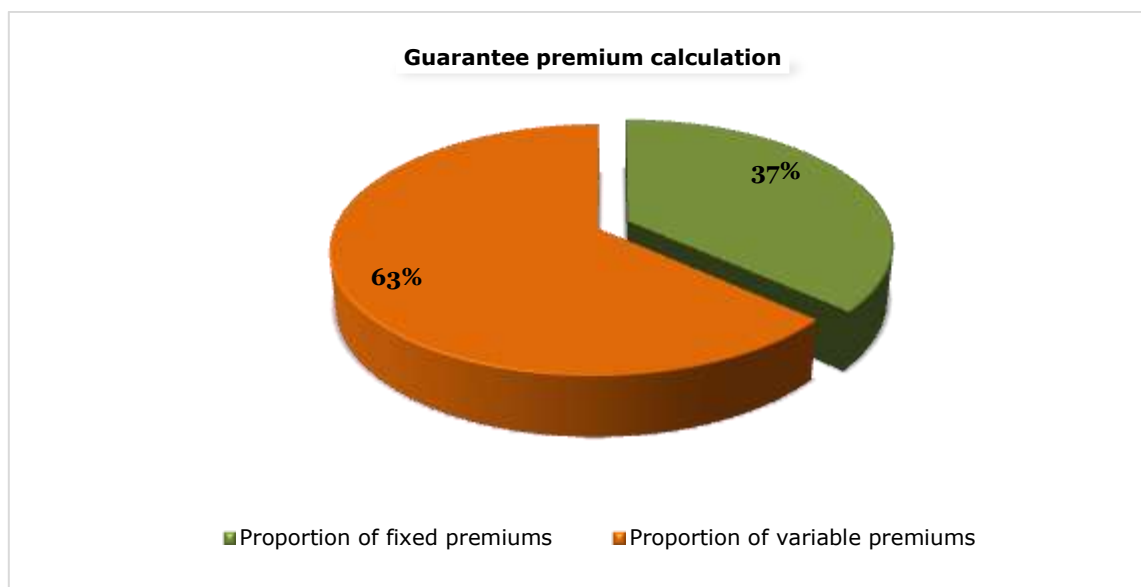


### 3. CALCULATION OF THE GUARANTEE PREMIUM

Aside from the calculation basis, it matters to know how the guarantee premium is calculated, i.e. whether it is a fixed premium or whether it is variable according to certain criteria.

The feed-back from the survey shows that for 11 out of 30 respondents, the guarantee premium is

fixed: 9 have absolutely fixed premium, irrespective of the guarantee coverage rate, and for 2 respondents the premium is based on a fixed rate, but varying in accordance to the guarantee coverage rate of the loan (coverage rate ranges).

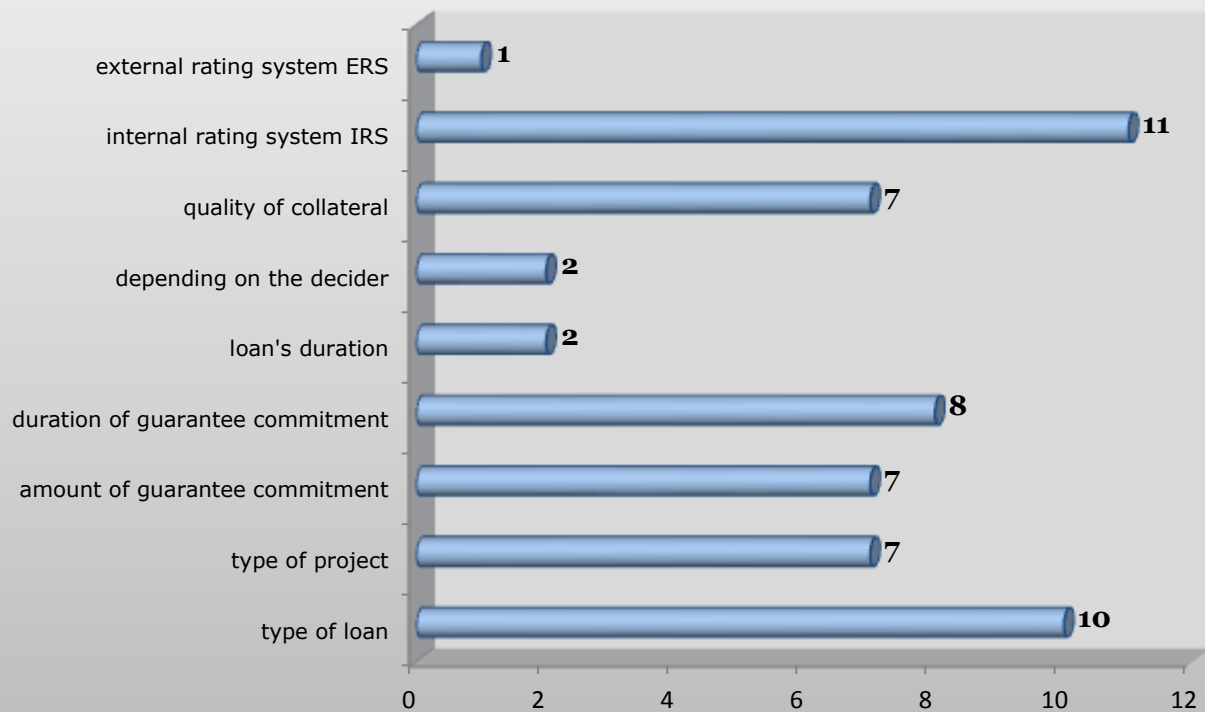


For 19 out of 30 respondents or 63%, the premium is variable, depending mostly on the Internal Rating System (11 responses), the quality of guarantees (7 responses), the duration of the

guarantee commitment (8 responses) and the type of loan (10 responses).

Many of them use more than one criterion at a time to determine the rate.

**Factors determining variable guarantee premium computation**





#### 4. GUARANTEE PREMIUM COVERAGE AND PAYMENT

##### a) What does the guarantee premium cover?

The guarantee premium has to cover a number of expenses to ensure the sustainability of the guarantee institution. The respondents have listed the following items:

- For 15 out of 28 respondents (54 %): the guarantee premium covers management/administrative costs and the risk premium.
- For 5 out of 28 respondents the premium only covers management/administrative costs,
- For 6 out of 28 respondents the premium only covers the risk premium,
- For 1 out of 28 respondents the premium partially covers management/administrative costs and risk premium,
- For 1 out of 28 respondents the premium partially covers the risk premium
- For 2 out of 30 participants in the survey did not answer this question

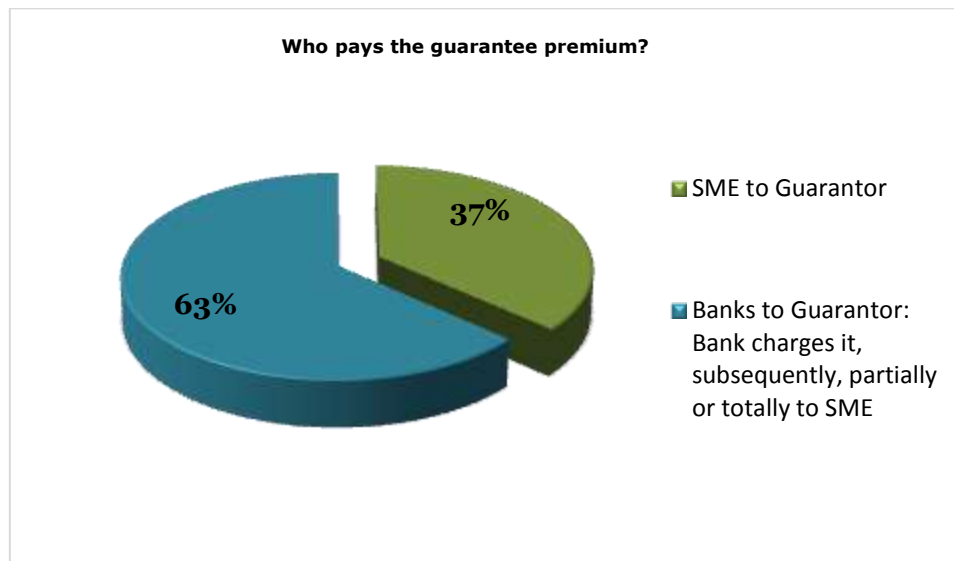
This shows that less than a half of the respondents cover certain cost items through other sources than the guarantee premium, e.g. through public support.

Asked if any additional fees (administrative or origination fees) except the premium are charged, 50% of the respondents answered that no other administrative fees are claimed except the premium. Moreover, 73% of the respondents answered that they do not charge other origination costs.

##### b) Who pays the guarantee premium?

Guarantee schemes usually work together with their partner banks, which often provide the main distribution channel for them. This makes sense, since banks usually have direct and regular contact with the SME beneficiary. It is therefore not surprising that for 63% of the respondents, banks

pay the guarantee premium to the Guarantor and subsequently charge it, partially or totally, to the SME. However, it is also interesting to note that for a substantial 37% of the respondents, the SME pays the guarantor directly, not transiting via the bank.



#### c) Subsidisation

The guarantee premium level is not only essential for the sustainability of the guarantee institution, it also has to be as affordable as possible for the SME beneficiary. Since it represents an additional cost on top of the interest rate (although in many cases it may at least be compensated in part by a reduction in the bank's interest rate), applying a too high premium would make the guarantee unaffordable. It is the reason why partial or full

public subsidies are granted to help SMEs to pay the guarantee premium.

The survey shows that 40 % of the cases examined, the SMEs benefit from a subsidy, either fully (2 out of 30 respondents – 6,7%) or partially (10 out of 30 respondents – 33,3%). One respondent did not provide an answer on this question.

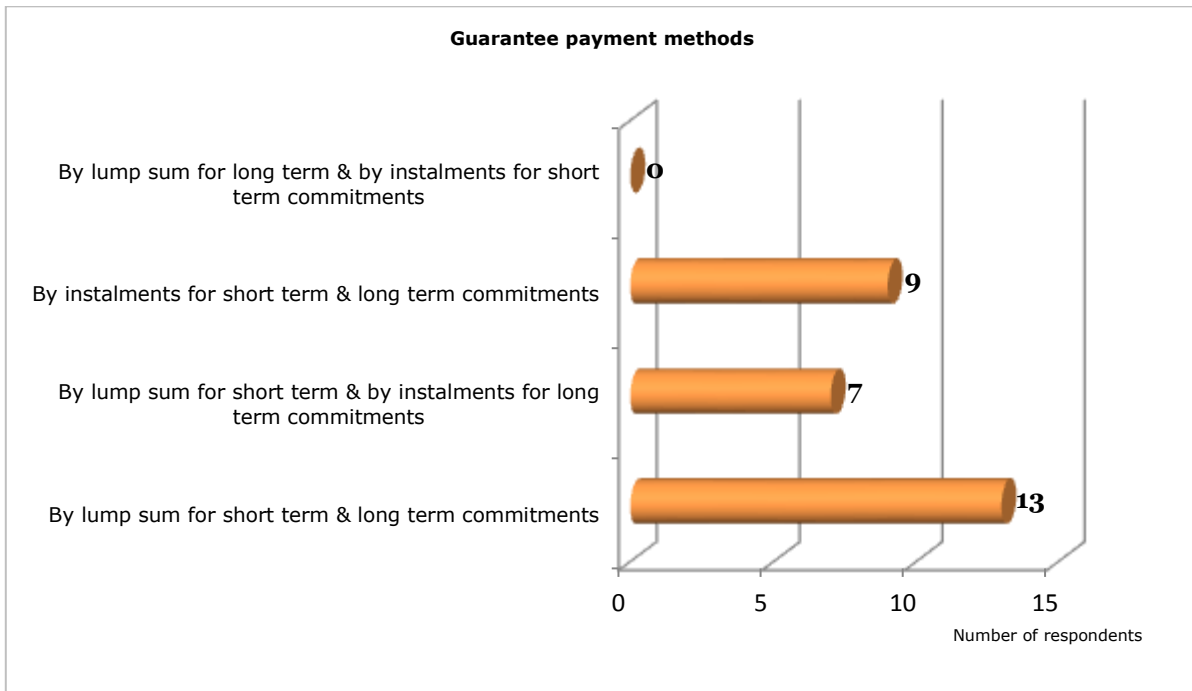
#### d) How is the guarantee premium paid: by lump sum or by instalments?

The payment method is also an important issue. The premium can be either charged as a lump sum upfront payment for the whole duration once the guarantee is issued, or it can be paid by instalments (annually or with another frequency).

by instalments depending on the maturity of the commitment.

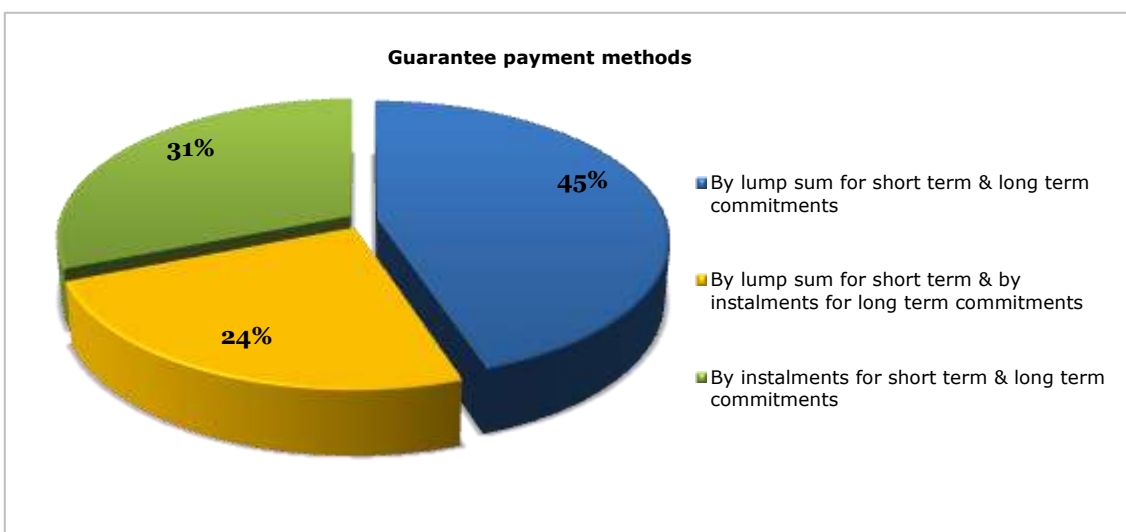
In general, 67% of the respondents charge the guarantee premium upfront by lump sum payment and 33% charge it mostly by annual instalments. Some respondents charge either by lump sum or

The charts on the next page show three groups regarding guarantee premium payment methods: In actual numbers, the respondents combine their guarantee premium payments methods, according to the duration of the commitments, in the following way:



The pie chart below shows that the majority of respondents charge a lump sum premium payment for short and long term commitments, followed by instalments premium payment for short term and long term commitments and a mix of premium

payment methods (for short term commitments by lump sum and for long term commitments by instalments).



e) Premium paid by instalments: how are unpaid premiums recovered?

The advantage of the upfront lump sum payment method for the guarantee scheme is of course that in case of default, at any time, the risk is covered for the whole period of the guarantee commitment. The payment of the guarantee premium by instalments in turn raises the question, how the outstanding premium is recovered if not paid by a debtor that defaults.

For the respondents (14 out of 30) who have their premium paid by instalments (including some of the respondents with a mix premium payment approach), the answers are:

- For 6 out of 14 respondents, the unpaid premiums are not recovered
- For 2 out of 14 respondents, the unpaid premiums are deducted from the guarantee's payment
- For 4 out of 14 respondents, the guarantee is cancelled
- For 2 out of 14 respondents, the agreement is renegotiated and then if not recovered, they will proceed through legal enforcement
- 1 out of 30 respondents did not provide an answer to the question.

f) Premium paid by instalments in the case of anticipated refund of the loan: what happens to the remaining premium?

A similar issue arises for guarantees, when the beneficiary repays his loan before the originally negotiated term. 15 members are not concerned by this issue, as they charge upfront lump sum payments.

5 survey participants did not answer the question, although they stated that they charge their payments by instalments.

Among the 9 effective answers:

- 2 out of 9 respondents require the anticipated payment of remaining premium
- 3 out of 9 respondents require a discounted payment of remaining premium
- 1 out of 9 respondents refund of the premiums for the uncovered period, if paid at the beginning of the year
- 3 out of 9 respondents: say that in case of anticipated refund of the loan, the payment of the remaining premium is not required

## 5. PRICING POLICY

AECM members were asked the question: *Is the pricing policy reviewed on a regular basis?*

Concerning their pricing policy revision methods:

- 28 out of the 30 participants to the questionnaire responded this question.
- 19 out of 28 respondents do not review their pricing policy as a rule on the basis of a portfolio evaluation (e.g. defaults, payment delays, etc.) whereas 9 do so.
- 18 responded that they do not review their pricing policy as a rule on the basis of

exceptional events (crisis, etc.) whereas 10 do so.

- 10 out of 28 respondents answered that their pricing system remains unchanged but input variables change (Parameters for risk assessment change, e.g. reference rates, sectorial reference data - the premium levels affected to the different rating/scoring categories are unchanged). And 18 responded that this is not their case.

The table below shows an overall overview of the combination of responses received concerning the pricing revision methods used.

Number of answers	Revision of the pricing policy:		Pricing system remains unchanged but input variables change (Parameters for risk assessment change, e.g. reference rates, sectorial reference data - the premium levels affected to the different rating/scoring categories are unchanged)	Verification of the conditions (yearly) but not leading necessarily to a revision of the pricing policy
	As a rule on the basis of a portfolio evaluation (e.g. defaults, payment delays, etc.)	As a rule on the basis of exceptional events (crisis, etc.)		
15	No	No		
6	Yes	Yes		
4	No	Yes		
3	Yes	No		
9	No	No	No	
3	Yes	Yes	Yes	
4				Yes



## **Conclusions**

This survey has raised interesting information about the manner in which AECM member organizations set up their pricing for their guarantee products.

The high response rate (30 members out of 38) demonstrates the interest of such a survey. The joint individual member-sheets are a first-hand material for members and could, therefore, serve as a reference if they plan to adapt or review their guarantee premiums.

One of the major findings of this survey is the great diversity of working methods. This concerns not only the conceptual aspects (e.g. the maximum duration of short-term, medium and long term commitments) but also and especially calculation policies for guarantee premiums. In this respect, none of them can be identified as optimal. Indeed, many factors are involved, including:

- The legal status of the guarantee scheme: public, private or mixed
- The presence or absence of a cooperative culture
- The provision of guarantees
- The target customers
- The length of guarantee commitments
- The direct or indirect subsidisation by public entities
- The economic and financial environment
- The possible use of methods developed for implementing the risk weighting dimension in the calculation of the guarantee premium.
- Etc...

Among the key lessons learned from a technical standpoint, one can particularly recall the following:

- For short term loans, the basis for calculating the guarantee premium is the nominal amount of the guarantee commitment for 64% of the

respondents (in case of overdrafts) and 74% of the respondents (in case of redeemable credit commitments). With regard to guarantees in the medium and long term, the members use the outstanding credit amount according to the effective repayment schedule (44% of respondents) or the guarantee nominal amount (33% of respondents).

- In 63% of cases, the guarantee premium varies depending on various factors and in 37% of cases, it is fixed.
- In 63% of cases, the bank pays the guarantee premium to the guarantee scheme and charges it partially or totally to the beneficiary.
- The guarantee premium is paid within 67% of cases at once upon the entry into force hereof, and in 33% of cases, the premium is paid on an annual basis.
- The pricing policy - and thus guarantee premiums - is not subject to periodic review at 19 members (out of 28 responses). At 10 members, different parameters and criteria for risk assessment are tailored to important developments, however, leading to changes in guarantee premiums. This reflects the concern of AECM members to ensure stability over time concerning levels of guarantee premiums, in order to best ensure their mission is to facilitate access to credit.

These observations and interesting lessons to more than one way up a base of information from which further research can be undertaken to better understand key aspects of the complex nature of guarantee schemes. The added value to the economy of this activity is now widely recognized and it is important to maintain and develop it through an appropriate pricing policy.









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