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AECM
EXECUTIVE SUMMARY

"The importance of Financial Intermediaries in SME financing and assessment of different economic effects especially of EU Financial Instruments in light of Direct guarantees vs. Counter-guarantee contracts"

DRAFT

September 2016

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EXECUTIVE SUMMARY

The European Association of Guarantee Institutions (AECM) represents the political interest of Guarantee Institutions both towards European Institutions and other multilateral bodies. The core business of its 42 members is to provide and enhance SMEs access to financing, hence contributing to economic growth.

AECM has the crucial role of supporting its members in the understanding of policy and regulatory developments in the area, anticipating market trends, analysing the interlink between them in a sound and clear manner, and eventually providing recommendations on how to tackle the compound effects of the two.

In this respect, one of the most striking changes occurred in the last few decades has been the greater availability of European Funds promoting access to credit. Indeed, the European Investment Bank Group (composed of European Investment Bank (EIB) and the European Investment Fund (EIF)), responded rapidly to the financial crisis with an anti-cyclical response (i.e. via securitisation, guarantees, risk-sharing loans and investments in venture and growth capital funds) in banking and capital markets, including those for SMEs. More recently, a clear tendency has been witnessed in making EU financing instruments available directly to commercial banks. This means that, on one hand, EU policies have been ensuring constant public support to SMEs, confirming the importance of guarantees as public goods; on the other hand, more players have been actively participating to the SMEs financing market, generating some confusion among the market players themselves. This confusion is likely to be generated by a perceived increase in competition within the market itself and the tendency to consider "guarantee sponsors" as market players, rather than facilitators and advocates of the ultimate rationale for the activities of Guarantee Institutions, that is to say, enhancing SMEs access to credit as public good.

More in detail, the EU (especially through the European Investment Fund (EIF)) can now issue guarantee contracts directly to commercial banks (the so-called "Direct Guarantee"); or, alternatively, can issue guarantee contracts with a Guarantee Institution (the so-called "Counter-guarantee"). It follows that the market of guarantees for SMEs is now populated by more players and more instruments as compared to the past, and Guarantee Institutions started to feel the impact of these changes.

In its representation role, AECM has therefore decided to undertake **this Study, whose aim is two-fold**:

- to provide **evidence of the impact** that Direct Guarantees are having (or will be likely to have in the near future) on the activity of Guarantee Institutions, the market, and ultimately on SMEs and the economic environment;
- to provide their members, and ultimately all other relevant stakeholders (including EU Institutions), with **policy recommendations** on how to face the challenges of the guarantee market.

1 Context

The importance of ensuring SMEs access to credit is widely recognised as the key instrument to boost economic growth, especially in Europe, where SMEs represent the majority of businesses.

In Europe, the incidence of the guarantee stock on real GDP was equal to about 1% in 2014, with peaks in Portugal and Italy (1.7% and 1.3% respectively). According to the "impact" analysis presented in this Study, the combined effects of public and private guarantees on the "wider economy" are even greater, considering that, ultimately, guarantees enable to generate more private investments in physical infrastructures, human capital and innovation. In fact, we estimated that the impact that an increase in investments generated by an increase in guarantees, calculated in line with historical market trends, might have on a country's GDP ranges between 0.18% to 0.43% of a country's GDP. It also generates an impact on the labour market, by reducing the number of unemployed (with a reduction by as much as 33.000 units in some markets).

In all major economies (with the only, partial exceptions being the U.S. and the U.K.), there is a guarantee system. **Everywhere access to credit is a "public good" and the guarantee system is**

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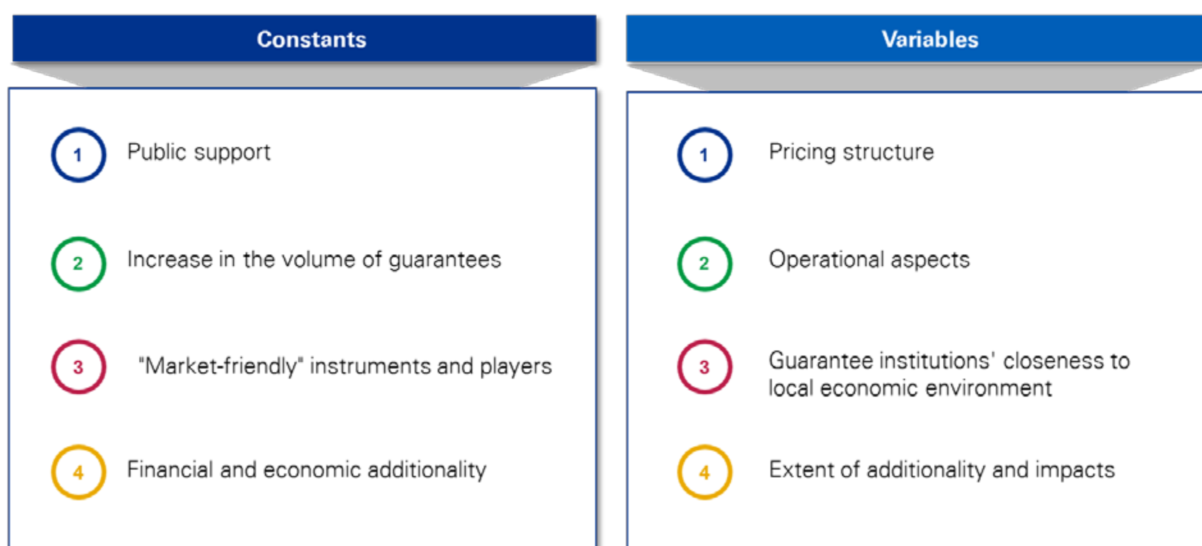
supported in different forms (directly and indirectly) **by the public**. The financial crisis contributed to widening the financing gap, generating a market failure, where supply of credit (particularly for SMEs and entrepreneurs) has not been able to meet an increasing demand. On one hand, traditional financing channels, such as commercial banks, dealing with the effects of the crisis and its aftermath, struggle to meet this demand, and money available for business loans is more limited than it appeared to be in the past. This tendency implies that the "shortlist" of businesses being able to obtain credit from banks is limited. And here comes the role played by public interventions, which can boost and empower significantly the role that intermediaries, *in primis* Guarantee Institutions, play in correcting the market failure, hence filling the gap.

2 Comparison of the efficiency of different types of guarantee models

The Guarantee schemes adopted around the world are diverse, in terms of three distinguishing factors: the nature of the funding, the legal and regulatory framework underlying them, and their operational characteristics. However, models which are the reflection of simplicity and of synergy with the pursued economic policy appear to be the most successful ones. Indeed, the "success" of guarantee schemes needs to be interpreted mainly as the ability of the market players to create synergies with both public and private financing instruments, with the final aim at improving SMEs access to finance. By analysing the different Guarantee models adopted across Europe **a few "constants" and "variables" can be isolated**, where constants represent common factors to most guarantee models, whereas variables are distinctive characteristics which define the peculiarities of different guarantee schemes and systems.



Within the constants, widespread and constant public support (both at national and supranational level), an increase in the overall volume of guarantees thanks to the availability of direct guarantees, market-friendly mechanisms to distribute public funding, and the generation of financial additionality and economic additionality seem to characterise most of the guarantee models. By contrast, the "variables" are concerned with operational aspects, among which, the extent of economic and financial additionality generated, the pricing structure, and Guarantee Institutions' closeness to the local economic environment. These are all aspects that can play a crucial role in affecting the guarantee market and potentially leading to market distortions. The operational aspects are mostly related to "go-to-market" strategies including the "distribution model", the players involved in the guarantee chain, as well as regulatory constraints, legal forms and sources of funding for any entities issuing guarantees. The pricing structure is concerned with the different types and amount of fees requested by guarantors and the proportion of the loan they are able to guarantee. Finally, the extent to which Guarantee Institutions are embedded within the local economic environment is mainly related to their network

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activities (e.g. lobbying, training), their operational catchment (e.g. national, regional, municipal), as well as geographical and sectoral coverage.

To evaluate the correlation between the activity of Guarantee schemes and the economic value generated is essential to look at the so-called "**financial additionality**", according to which Guarantee schemes are essential tools to allow credit access to SMEs which otherwise would not meet the requirements for obtaining loans from the banking system, thus creating positive effects on the economy as a whole, including well-being and other socio-economic aspects ("**economic additionality**").

Ultimately, the added value of a system devoted to improving SMEs access to credit relies on the ability of its players to generate both financial additionality and economic additionality (as explained later on).

Guarantee schemes facilitate access to credit for businesses which would otherwise be unable to obtain it, transforming the role of these players from "risk mitigators", by reducing banking system's information asymmetries, to "risk underwriters", in particular since the financial crisis, when guarantee schemes started once again to become important ways to improve access to credit and offer credit leverage (or financial additionality), rather than being mere credit risk mitigators as in the past.

However, **as compared to the immediate aftermath of the financial crisis** when Guarantee Institutions used to be almost the sole credit access tool for most SMEs, more recently, two major trends started to have an impact on their activities.

First, the **increasing role that EU Institutions play in providing Financial Institutions with public money** available for granting credit to SMEs, meaning more public funds are available to improve SMEs financing.

Second, a greater openness of EU Institutions towards the signature of guarantee contracts directly in favour of more traditional financing channels, such as commercial banks.

The compound effect of these two changes appear **to generate unintended consequences on the Guarantee market, and, ultimately, on the activity of Guarantee Institutions**. The key point relies in fact on how public money are channelled to the final recipients, SMEs, and on clearly identifying the key players within the market by distinguishing them from the tools and instruments which are the "sponsors" providing the means for SMEs financing.

3 "Direct guarantees" vs. "Counter-guarantees": potential effects of direct guarantees on the market and on Guarantee Institutions

To do so, one has to first analyse the added value that Guarantee Institutions bring about and why they are believed to be the most suited institutions to provide SMEs with financing. Second, the potential distortionary effects that an increase in the number of Direct Guarantees might generate needs to be looked at, and understand the value chain that different players generate within the market.

Starting with the added value generated by Guarantee Institutions, there is wide agreement (both in empirical studies and in the literature) that three advantages are brought by Guarantee Institutions, which can:

- reduce informational asymmetries between agents;
- limit "adverse selection" (for high-risk borrowers) and "moral hazard" (for existing borrowers) mechanisms;
- fill the financing gap, working as wealth-pooling mechanism.

Guarantee Institutions have deep knowledge of the local market, are able to thoroughly assess SMEs needs for financing and their "ability" to re-pay the loan, and, in some cases, to support them through advisory services that increase their "transparency" towards the banks. Informational asymmetries between lenders (e.g. banks, Guarantee Institutions) and SMEs borrowers was exacerbated by the

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financial crisis. Micro and SMEs in many cases are not "financially-savvy" enough to convince banks they are able to repay the loan or to fulfil the minimum requirements. Because of that, on one hand, banks tend not to finance SMEs who would really be in need of financing, either for survival or for making investments and grow their business; and these SMEs will also tend to be those classified as "high-risk borrowers". Additionally, banks see their relationship with Guarantee Institutions as key; indeed, in most cases, the banking system has the right incentives to recognise the role of Guarantee Institutions and create synergies with them; and not only because of their role as guarantors, but also because, thanks to their relationships and knowledge of the local market, they are able to bridge the information gap (and the trust gap) which characterise the relationship between banks and SMEs. It follows that, if Guarantee Institutions deny the request for guarantee, banks are very unlikely to issue the loan or they tend to impose stricter conditions, by means, for example, of higher interest rates or even requiring further guarantees. In this way, more credit should be available and at better conditions, a higher number of SMEs should be able to obtain credit, and adverse selection mechanisms (leading to the attraction of high risk borrowers) should be limited.

There are many advantages both for banks and Guarantee Institutions deriving from Counter-guarantee activities.

With regard to **advantages to the commercial banks**, it is important to highlight the following:

- an increase in the volume of credit issued benefitting from guarantee coverage;
- selection and short-list of "more deserving" SMEs carried out directly by the Guarantee Institutions, lightening the operational burden for the bank and speeding up the process;
- decrease in the number of non-performing loans;
- reduction of capital adequacy needs (potentially to a greater extent than in Counter-guarantee, as shown in one of the case studies);
- easing of overall operational activities (e.g. paperwork, application, issue of the guarantee).

As far as the **advantages to the Guarantee Institutions** are concerned, a few aspects can be considered, including the following:

- increase in the capital of Guarantee Institutions which can be freed-up, hence increasing "issuable" guarantees;
- deep knowledge of the market and SMEs;
- targeted assistance and support to the SMEs;
- loss coverage.

Moving onto the **distortionary effects** that could break into the market and interrupt this virtuous and smooth incentives cycle, this Study identifies and collects relevant evidence on some key distortionary effects, presenting relevant case studies helping to understand the key challenges, as well as to suggest successful tools for market correction.

First, direct experience and interviews with key players and AECM members show that the first effect that EU Direct Guarantees might have onto the guarantee market is **a perception of uncertainty and misalignment of incentives** between the key players within the market: Guarantee Institutions and Banks. Moreover, there is some widespread confusion between **who the key players are (or would need to be) and what sponsors and instruments are available**. Some of the interviewed members revealed that, rather than EU direct guarantees being perceived as sponsors, or in other words, as deploying public money through instruments that can re-distribute it, are currently treated as an additional player within the market, hence generating "unfair" competition. Although very difficult to test and being evidenced in quantitative terms, it is important to bring attention to it, and eventually investigate it further in future research. It is perhaps too early to tell by means of reliable data, but it is AECM's role to bring attention to this.

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Second, one of the key impacts is the so-called "**deadweight effect**", according to which particularly favourable conditions applied by the EU to commercial banks when issuing funding for direct guarantee (e.g. the cost of the guarantee itself) are providing an incentive for banks to use the guarantee even when unnecessary. When the guarantee is free (i.e. no fees are requested to the bank) or quasi-free (i.e. fees are very low), the deadweight effect can appear when the bank takes a guarantee on the loan which it could have accepted even without the guarantee, therefore with no additionality generated. Three main motives could lead to this deadweight effect:

- to reduce capital adequacy needs, or
- to replace available securities for commercial reasons, or
- operational reasons and advantages.

The deadweight effect has two important indirect effects, as shown by the case studies presented in the Study with regard to the experience of Austria, Bulgaria, Spain and Italy:

- an **effect on the number and volume of guarantees** (up to 40% reduction in some cases analysed in the Study) issued in favour of the banks which have signed a direct guarantee directly with the EU;
- an **effect on the quality of credit**, meaning that the outstanding guarantees which continue to be issued to those commercial banks tend to belong to a higher risk rating class (for instance, in the Austria case study, the average rating class of the guarantees provided by the Austrian Guarantee Institutions aws in favour of one bank which had signed a direct guarantee contract with the EIF went from 13 in 2011 to 19 in 2016 - where 1 is the lowest risk class and 24 is the highest risk class). It can be implied that those commercial banks would be willing to collaborate with the guarantee institution only for riskier cases.

Clearly, the deadweight effect cancels out the "win-win" situation which, theoretically, should characterise the relationship between banks and Guarantee Institutions, providing them with the right incentives to issue Counter-guarantee, and also being able to free capital for other activities.

Third, and strictly linked to the deadweight effect (and consequential limitations to the creation of financial additionality), there is the **"rich-get-richer and poor-get-poorer" behaviour** from a SME perspective. There is preliminary evidence coming from the guarantors' experience that if the EU signs a contract directly with a commercial bank to issue guarantees, the commercial bank will likely to grant the loan to firms already having a relationships with the bank, and which would have had anyway access to finance through the bank, taking advantage of other instruments. Empirical evidence is available (Spain case study) that commercial banks explicitly suggest their existing borrowers to ask for a guarantee directly issues to them from the EU in the form of direct guarantee, so that the bank is able to cover current risks through the guarantee, with no need to increase their risk class. Therefore, there might be a distortionary selection, implying that "disadvantaged SMEs" (i.e. those struggling to obtain credit) are being left out. These tend to be micro enterprises or single entrepreneurs, start-ups or innovation companies.

Fourth, empirical evidence (as also shown by the Italian and the Spanish case studies) shows that the so-called "**leverage effect**" generated by Counter-guarantees is much higher than the leverage generated by direct guarantees. The leverage effect is a multiplier effect generated within the guarantee system, based on which guarantee institutions can grant more than they actually have, because they have to pay for the actual amount granted to SMEs if and only if SMEs do not pay their debts back to financing banks. Calculated as the ratio between the outstanding loans guaranteed to the underlying own funds of the guarantee scheme, the extent of the leverage effect depends on whether credit is short-term or long-term credit, and it is certainly a favourable element if and only if it is managed properly. As explained in the Study, the value chain of Direct Guarantees is the result of the guarantee activity of one single player, namely the bank, taking advantage of a single guarantee instrument, namely the EU scheme. As such, SMEs guarantees can be a source of funding or regulatory capital relief, which in turn generates leverage effect into the economy, thanks to the investments that SMEs can make, generating economic value into the local and national economy. However, the value chain of Counter-Guarantees implies that an additional player, the Guarantee

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Institutions, take a role guaranteeing for the SMEs on the loan they take with the commercial bank, ensuring also a higher capital relief for banks (for instance, in Italy the capital relief for banks is 56% higher in case of Counter-guarantees than in the case of Direct Guarantees). Indeed, the value chain of Counter-Guarantees implies that both players can benefit from funding or capital relief: leverage is generated both from the bank and the guarantors; together with the "catalytic effect" born by SMEs investments into the economy, this can translate into a much higher economic additionality. For instance, a good example is given by the effect that can be observed in countries like Italy and Spain where national public funds are established to support SMEs financing, also through direct guarantees. Since not many data is yet available on the effects that the EU financing programmes 2014-2020 through direct guarantees are having on guarantee institutions (it is just too early to tell), a benchmark analysis can be carried out by looking at the effects that National Direct Guarantees have had over the years in some EU countries. It can be estimated that the leverage effect generated by Guarantee Institutions in countries such as Spain and Italy can range between 12.5 euros (Spain) and 13.3 euros (Italy) every 1 euro counter-guaranteed by Guarantee Institutions. By contrast, the effect of Direct Guarantees is estimated between 4 euros and 4.7 euros respectively. It is straightforward to see that a combination of private and public schemes might thus be more efficient and beneficial to the economy than a private only or public only scheme, also because of the added value of boosting capital flows during downturns. In other words, synergies between public and private players generate both financial and economic additionality.

Fifth, and as a consequence of the impacts briefly described above, it might well be that **public funding** to enhance firms' global competitiveness and economic growth **is allocated inefficiently**. And in this way, policy responses and the foundation for Guarantee Institutions might fail the rationale behind their activities. Far from being straightforward to measure, the inefficient allocation of public money can only be challenged by measuring and monitoring the impact that public policies and investment can have on the local economy as a whole over the years. If and only if the design of public policy and programmes to enhance SME access to finance can ensure financial (i.e. public support reaches viable enterprises which would not otherwise had access to finance or would have accessed finance at tighter conditions, such as higher financing costs, shorter debt maturity) and economic (i.e. public intervention produces a net positive impact on the economy as a whole) additionality, paying attention to the targeted SMEs population, eligibility criteria, credit risk management and fees structure; then a public scheme can be successful, since public programmes for SMEs should help catalyse and leverage the provision of private resources, especially in risk capital markets.

4 Policy recommendations

In light of the evidence gathered, a few recommendations to relevant stakeholders can be summarised as follows:

1) greater c**omplementarities and synergies between existing instruments and players**, at all levels, national and supranational, which have **aligned incentives to create "win-win" situations** for Guarantee Institutions, banks, national and supranational public institutions, and SMEs;

2) increased **efficiency in the use of public money**, achievable through a greater deployment of public money channelled through Counter-guarantees, generating greater leverage effect on the market and on the wider economy;

3) clear **distinction between sponsors and players** within the guarantee market, by recognising Guarantee Institutions as main players generating financial and economic additionality, supported by EU institutions as main sponsors, according to the rationale behind guarantees to increase SMEs access to credit as public good;

4) **increase in data availability for systematic measurement of efficiency in the deployment of public money**, allowing for market performance and efficiency measurement.

The main results of the Study, briefly described in this Executive Summary, are described in the document attached, split into four different sections.

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The first section starts with introducing the Context within which Guarantee Institutions operate in Europe, explaining the rationale behind their activity, the main players involved, and the effect they may generate on the wider economy. To conclude this section, the latest data on market trends are briefly reported.

Then, the second section includes an overview of the different types of guarantee models adopted by different countries across Europe, presenting a few criteria useful for building a taxonomy of guarantee models. A few key characteristics an efficient guarantee models should have in order to alleviating market failures in SMEs financing are also discussed.

The third section reports results and insights which can be considered as the core of the Study, by looking at the different value chains built around Direct Guarantees and Counter-Guarantees, followed by a discussion of the main distortionary effects caused by Direct Guarantees on the guarantee market: deadweight effect, self-selection effect, leverage effect and inefficient allocation of public money.

The document concludes with policy recommendations representing the synthesis of the insights emerging from the analysis.

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