Study project on "*The importance of Financial Intermediaries in SME financing and assessment of different economic effects especially of UE Financial Instruments in light of direct guarantee vs. counter-guarantee contracts*"

European Association of Guarantee Institutions

Board of Directors, Paris

23nd September 2016

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Context

The importance of SMEs' access to credit

SMEs' access to credit enables economic growth

- 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

Access to credit is a "public good"

- Therefore, **access to credit can be considered as a "public good"** because of its social and economic function
- **Rationale for public intervention**

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The importance of a Guarantee system

Market failure

- **SMEs are typically at a disadvantage with respect to large firms when accessing finance,** owing to **opacity, information asymmetry**, under-collateralisation, high transaction costs and lack of financial skills
- **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

Guarantee system

- SME financing remains high on the political agenda in most areas of the world and **credit guarantees remain the most widely used instrument to ease access to finance for SME**
- **Credit guarantee schemes alleviate the market failure and stimulate investment and social and economic growth**

- **An increase in investments generated by an increase in guarantees**, calculated in line with historical market trends, **might have a relevant impact on a country's GDP and on the labour market**

Impacts on GDP

Impacts on labour market

Unemployment up to (-33k)

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Comparison of the efficiency of different types of guarantee models

Comparison of the efficiency of different types of guarantee models
Advantages of Guarantee Institutions and Counter-guarantees

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

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

Advantages deriving from Counter-guarantees

Banks

- **Increase in the volume of issued credit** which is covered by the guarantee
- 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**
- **Easing of overall operational activities**

Guarantee Institutions

- 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**

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Comparison of the efficiency of different types of guarantee models

Constants and variables: how does an efficient guarantee system look like?

- 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

Constants

1 Public support

- national support (e.g. the Italian guarantee fund "Fondo di Garanzia") and supra-national support (e.g. EIB Group)

2 Increase in the volume of guarantees

- increasing volume of guarantees over the years, also related to the increase in the volume and number of Direct Guarantees

3 "Market-friendly" instruments and players

- market-friendly mechanisms to distribute public funding, because of the "nature" of Guarantee Institutions

4 Financial and economic additionality

- credit access to "disadvantaged SMEs" and positive effects on the economy as a whole

Variables

1 Pricing structure

- different types of fees and percentage of the loan which is guaranteed

2 Operational aspects

- "go-to-market" strategies and distribution model
- involved players, ownership, legal form and source of funding

3 Guarantee institutions' closeness to local economic environment

- network activities, operational catchment, geographical and sectoral coverage

4 Extent of additionality and impacts

- extent of the financial and economic additionality created, embedded into the Guarantee system architecture

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Comparison of the efficiency of different types of guarantee models

Key changes in the Guarantee system

- The following are the most striking changes occurred in the last few decades which might have/have had an impact on the Guarantee system, therefore on the activity of Guarantee Institutions

Greater availability of European Funds

- Greater availability of European Funds promoting access to credit.
- Indeed, the European Investment Bank Group responded rapidly to the financial crisis with an anti-cyclical response in banking and capital markets, including those for SMEs

Direct Guarantee

- More recently, a clear tendency has been witnessed in making EU financing instruments available directly to commercial banks
- 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")

Which is 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?

Opportunity: Public intervention to fill the gap

Risk: Potentially, inefficient allocation of public funding

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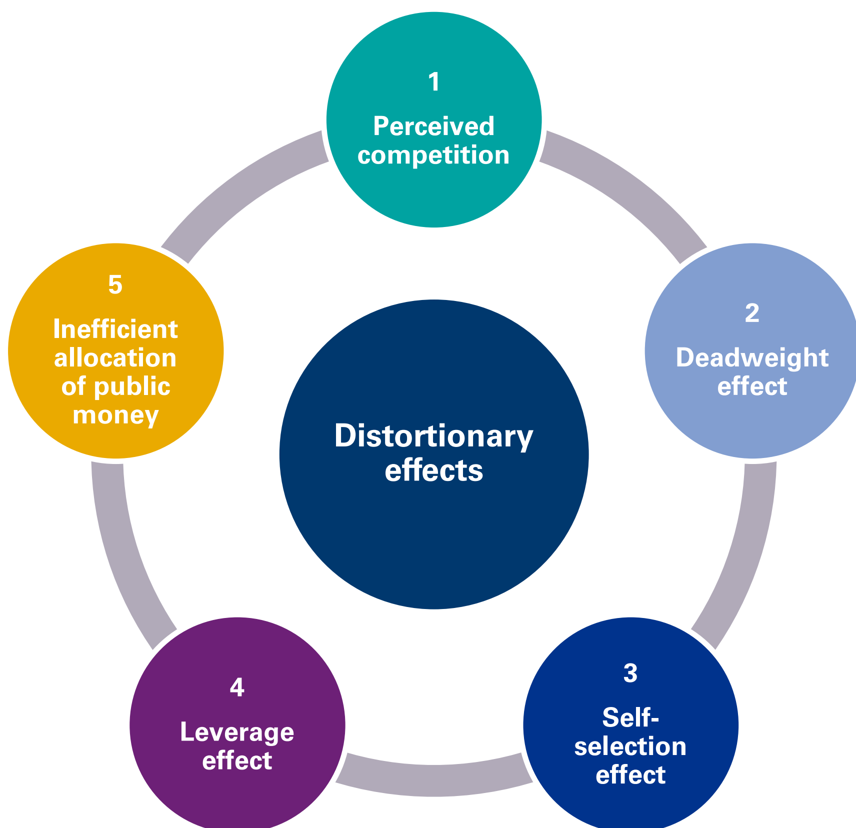
"Direct guarantees" vs "counter-guarantees"

"Direct guarantees" vs "counter-guarantees"

Impacts of direct guarantees



1 **Perceived competition**

Perception of uncertainty and misalignment of incentives; indeed the EU direct guarantees rather than 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 causing "unfair" competition

2 **Deadweight effect**

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

3 **Self-selection effect**

Strictly linked to the deadweight effect, there is the "rich-get-richer and poor-get-poorer" behaviour from a SME perspective. 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

4 **Leverage effect**

Empirical evidence shows that the so-called "leverage effect" (or "additionality") generated by counter-guarantees is much higher than the leverage generated by direct guarantees

5 **Inefficient allocation of public money**

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

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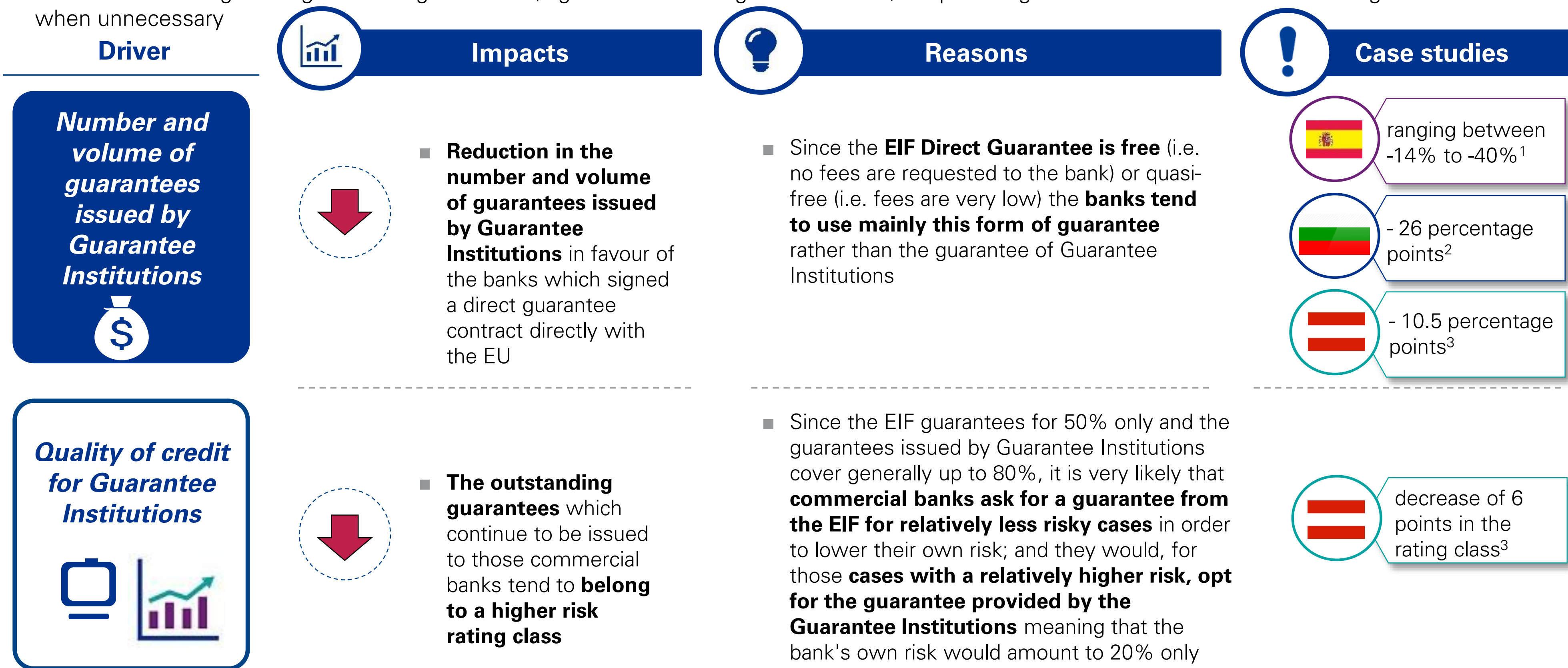
"Direct guarantees" vs "counter-guarantees"

Distortionary effect: Deadweight effect

- 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 guarantees (e.g. the cost of the guarantee itself) are providing an incentive for banks to use the guarantee even when unnecessary



A few Countries have so far had direct experience of those indirect effects

Note 1: Reduction since the beginning of 2015, when was implemented the SME Initiative Progam
Note 2: Reduction with respect to the previous guarantee program, when the agreement between the bank and EIF was not in use yet
Note 3: Reduction since the end of 2013, when the bank started to benefit form the direct guarantee provided by EIF

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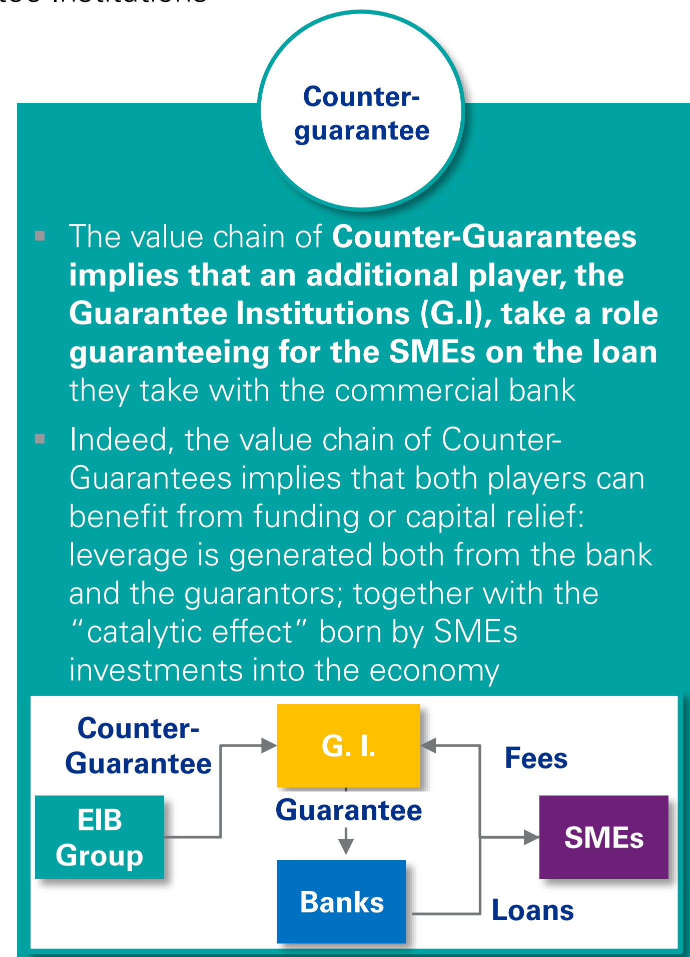
"Direct guarantees" vs "counter-guarantees"

Distortionary effect: Leverage effect (1/2)

Leverage effect

- The leverage effect is a multiplier effect generated within the guarantee system
- 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
- The leverage is calculated as the **ratio between the outstanding loans guaranteed commitments to the underlying own funds of the guarantee scheme**
- A higher leverage effect, if managed properly, could generate a higher financial and economic additionality

- Empirical evidence shows that the so-called "**leverage effect**" (or "additionality") **generated by Counter-Guarantees is much higher than the leverage generated by Direct Guarantees**, thanks to the presence of an additional player: the Guarantee Institutions



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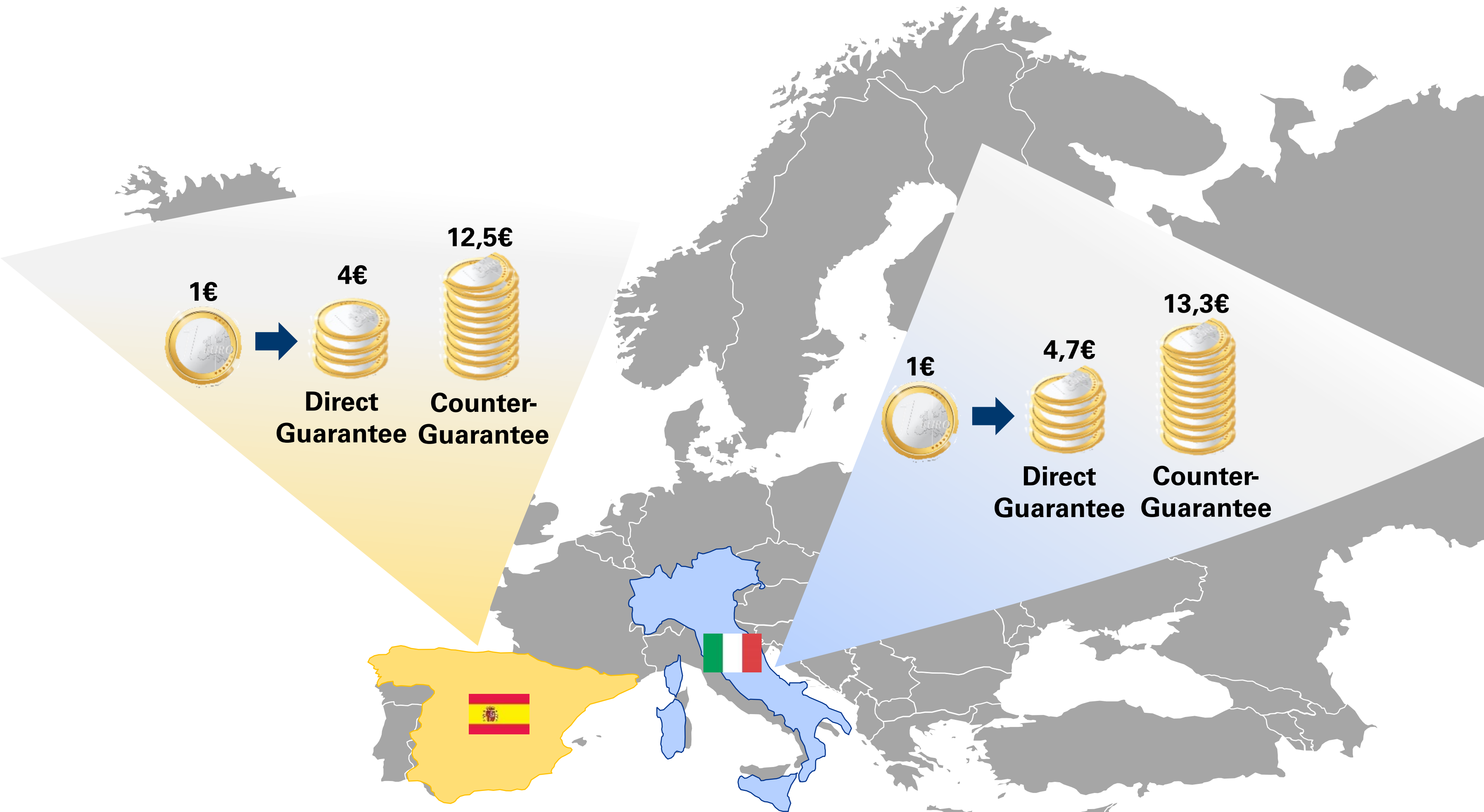
"Direct guarantees" vs "counter-guarantees"
Distortionary effect: Leverage effect (2/2)

Case studies: What is the leverage of 1€ invested?



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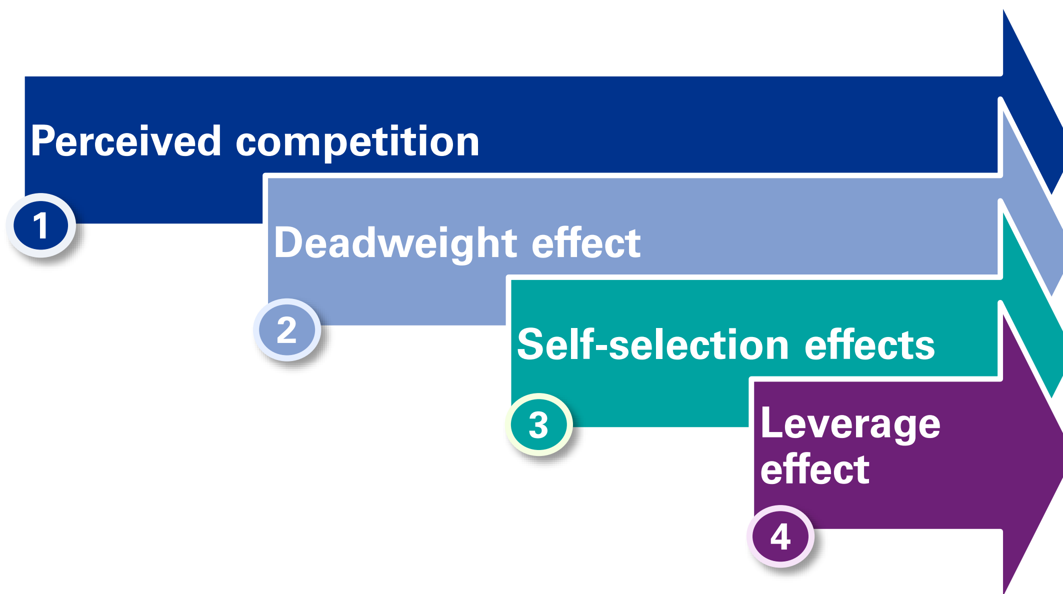
Distortionary effect: Inefficient allocation of public money



5 Inefficient allocation of public money

- **Failure to ensure financial and economic additionality to the target SMEs population** (i.e. public support reaches viable enterprises which would not otherwise had access to finance or would have accessed finance at tighter conditions, and lower impact on the economy as a whole)
- **Inability to catalyse and leverage** the provision of **private resources**, especially in risk capital markets
- The inefficient allocation of public money can only be challenged by **measuring and monitoring the public policies and investments' impact** on the local economy as a whole over the years

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Policy recommendations

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Policy recommendations

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

Complementarities and synergies: Greater complementarities and synergies between existing instruments and players, at all levels, national and supranational

Distinction between sponsors and players: 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 sponsor of the activity of Guarantee Institutions

Efficient use of public money: 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

Data availability: Increase in data availability for systematic measurement of efficiency in the deployment of public money, allowing to measure market performance and efficiency

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