CMM RESEARCH NOTE

Credit Guarantee Schemes for SMEs

Sharpening an Old Tool

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INSTITUTE OF INTERNATIONAL FINANCE

Small and medium-sized enterprises (SMEs) are vital to creating jobs and spurring economic growth, yet many lack access to finance. The IFC estimated a financing gap of $1.6 trillion in 2011 for the formal SME sector, which has likely increased since then (Chart 1). The G20, B20, and IFIs have been leading efforts to address this gap, as have national governments. As part of these efforts, credit guarantee schemes (CGSs) are an important policy tool to address the SME financing gap. By providing partial risk coverage of funding, CGSs can enable banks to finance SMEs that lack sufficient collateral or lower the cost of borrowing to higher-risk SMEs.

Many governments in advanced economies have decades of experience operating public CGSs, including Japan, the U.S., and Canada, while in Europe, there are many private or hybrid schemes. CGSs have also been in operation in emerging economies and are becoming increasingly prevalent. Since the 2008 global financial crisis, the total number of existing schemes has grown, and in many countries, the volume of guaranteed loans under existing schemes has grown as well (Chart 2). The OECD reports that public guarantee schemes are the most widely-used measures by governments to address SME financing for the countries in its Scoreboard.

As a member of the World Bank's *Task Force for the Design, Implementation and Evaluation of Public Partial Credit Guarantee Schemes for Small and Medium Enterprises* (Box 1), the IIF has surveyed banks regarding the existence and usage of such schemes.

SURVEY RESULTS: STRONG GROWTH IN CGS USAGE

The IIF conducts a quarterly survey of banks based in five emerging market regions (Emerging Asia, Latin America, Emerging Europe, Middle East & North Africa and Sub-Saharan Africa) to assess bank credit conditions. The ad hoc questions related to credit guarantee

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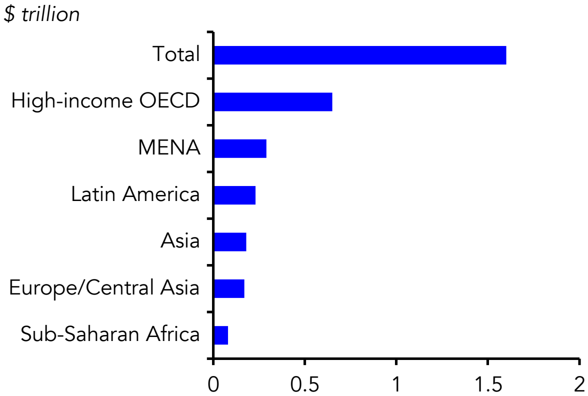
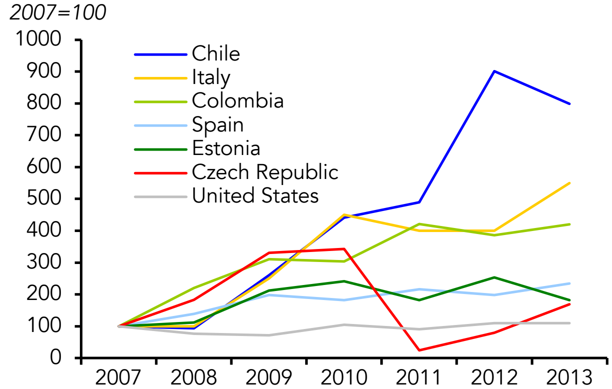
Chart 1
SME Financing Gap
$ trillion



Source: IFC.

Chart 2
Government Loan Guarantees for SMEs, 2007-13
2007=100



Source: OECD.

schemes were the following:

- Is there a credit guarantee scheme in your country that can be applied to provide finance to SMEs? If yes, is the scheme public or private?
- If there is a credit guarantee scheme, how often does your bank use the scheme to provide finance to SMEs?
- What are the biggest impediments to using the credit guarantee schemes?

We received responses from 124 banks, and of these, over 80% report that there is at least one such scheme in their country, with the highest percentage reported by banks in emerging Europe (Chart 3). The World Bank estimates that more than half of all countries have some type of credit guarantee scheme.

WHAT TYPE OF CREDIT GUARANTEE SCHEME?

Credit guarantee schemes vary widely in type, design, and delivery. Broadly, three types can be identified: 1. Public guarantee schemes managed by government agencies or ministries; 2. Private schemes, which are often mutual schemes such as the Italian *confidi*; and 3. Hybrid public-private schemes, which can originate from either the public or private sector. One successful hybrid is the Portuguese mutual guarantee system, which originated as a pilot public sector initiative before many of its operations were then transferred to the private sector. Among the surveyed schemes, public and hybrid schemes represent the majority (55% are public, 32% are public-private, and 13% private). Banks in emerging Asia reported the highest percentage of public schemes—indeed, no private schemes; while those in sub-Saharan Africa and MENA reported a more even distribution between the three types (Chart 4).

Credit guarantee schemes operate either on an individual loan or portfolio basis, with individual delivery typically providing much higher coverage than portfolio delivery, as the guarantor often conducts a separate risk assessment on individual loans. Sometimes governments or other institutions provide counter-guarantees for CGS to enhance their viability and reputation.

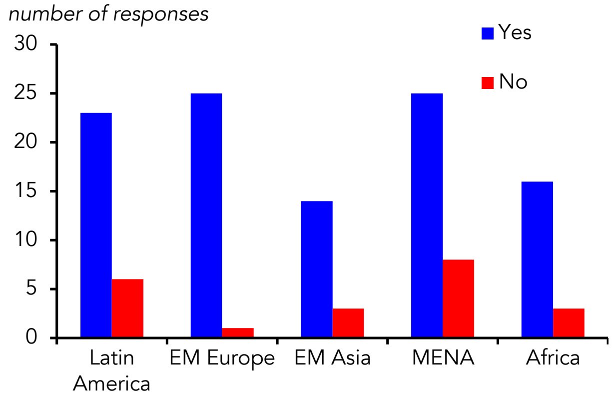
OVERCOMING IMPEDIMENTS

Most banks reported using credit guarantee schemes in their SME lending. Total reported usage of credit guarantees ranged between "always" (5%) and "never" (13%), with the highest number of banks reporting "sometimes" (51%) followed by "often" (32%). On a regional basis, usage in Latin America saw high percentages reporting for both the categories "always" (13%) and "never" (22%), and 27% of banks in sub-

Box 1: World Bank Task Force

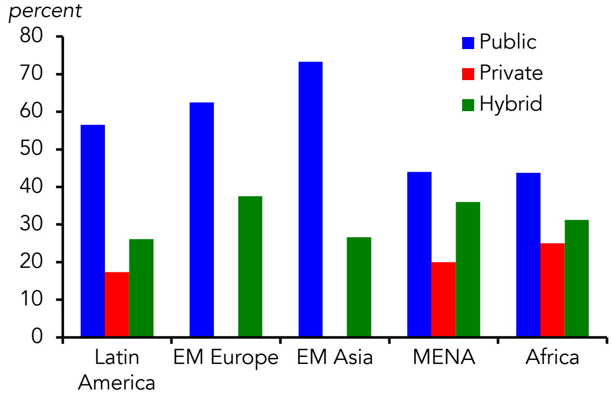
Established this year, the Task Force is developing a set of nonbinding principles and best practices for the design, implementation and evaluation of public CGSs in emerging markets and developing economies, which are expected to be publicly released by the end of the year. As they are a relatively new tool in many emerging and developing markets, a set of best practices is needed to guide in development of schemes that provide maximum benefit and the least amount of market distortion. Other members of the Task Force include: the Arab Monetary Fund, the Asian Credit Supplementation Institution Confederation, the Association of African Development Finance Institutions, the European Association of Mutual Guarantee Societies, and the Ibero-American Guarantee Network.

Chart 3
Credit Guarantee Schemes for SMEs
number of responses



Source: IIF.

Chart 4
Type of Credit Guarantees by EM regions
percent



Source: IIF.

Saharan Africa reported never using them (Chart 5).

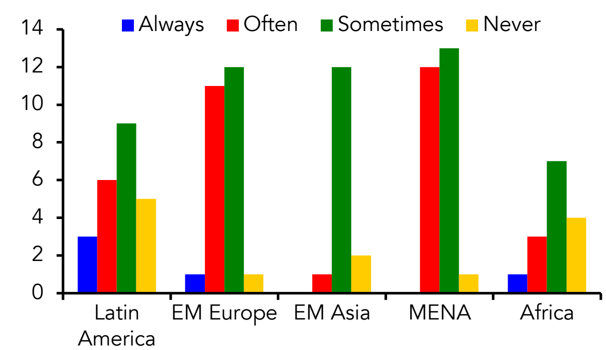
Of the reported impediments to the usage of credit guarantee schemes, there are two categories: those specific to the design and implementation of credit guarantee schemes—including fees, recovery mechanisms, regulatory treatment, and eligibility criteria—and those that relate more broadly to SME financing, such as **lack of demand from creditworthy borrowers**, the **availability of financial information**, and **requirements for collateral**. While CGSs are designed to address the latter two, many banks still reported these as significant in restricting overall usage of CGSs. Banks often require collateral to cover the portion not covered by the guarantee and, in the survey responses, assigned the highest weight to inadequate collateral (Chart 6). In many emerging and developing markets, there is also a lack of framework to make use of "moveable" assets such as inventory and receivables as collateral.

Among impediments that relate to the design and implementation of credit guarantee schemes, legal enforcement of the recovery process stood out as the highest-scoring impediment in most regions (Chart 7). Often, the **lack of efficient and effective recovery processes** may reflect the overall legal environment in specific markets. **Fees charged by guarantee schemes** are often upfront or on an annual basis and increase the overall cost of borrowing as they are typically passed on to the SMEs. In some regions, such as sub-Saharan Africa, these fees may be too high and restrict take-up of guarantees. Other impediments to usage of CGSs relate to banks' internal processes and lack of demand from lending units, specific restrictions on usage such as caps on loans, usage for certain economic sectors, restrictions on ownership structure of SMEs, and a lengthy or complex process in applying for guarantees.

Under the Basel Framework, the use of government guarantees can provide capital relief to banks. The credit rating of the guarantor can be used for the covered portion of loan provided certain criteria are met, thus reducing the risk weighting. Although regulatory treatment was ranked as the least significant of the impediments to usage, in some cases, national regulators in emerging and developing economies have not recognized credit guarantee schemes as meeting Basel criteria.

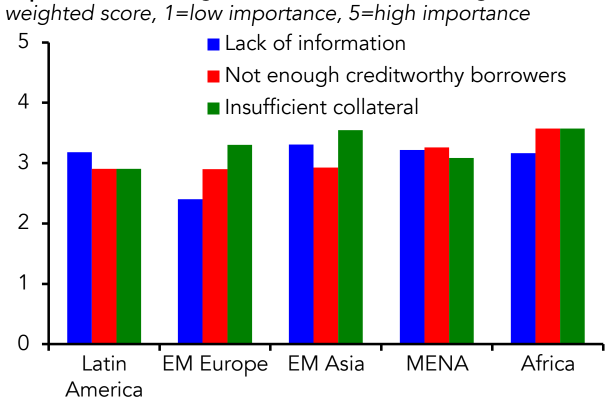
As public CGSs become more prevalent, governments, in collaboration with the private sector, should seek to find ways to address these impediments in order to maximize the role of guarantees in alleviating the SME financing gap.

Chart 5
Usage of credit guarantees by banks
number of responses



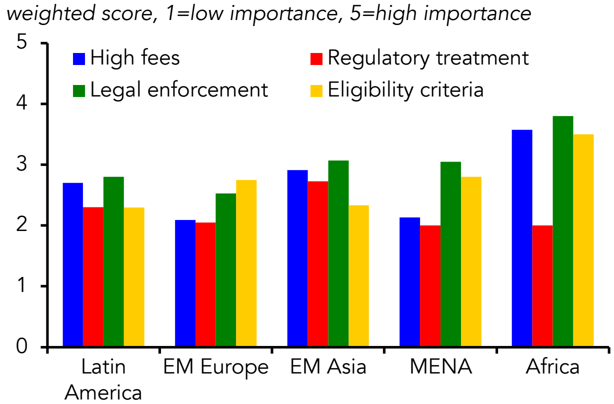
Source: IIF.

Chart 6
Impediments to Usage: General to SME Financing
weighted score, 1=low importance, 5=high importance



Source: IIF.

Chart 7
Impediments to Usage: Specific to CGSs
weighted score, 1=low importance, 5=high importance



Source: IIF.