

Spotlight 4.1

Public credit guarantee schemes

Public credit guarantee schemes (PCGSs) are a policy tool used widely by governments to ease access to finance for firms—especially small and medium enterprises (SMEs)—while limiting the burden on public finances. Akin to an insurance product, a PCGS provides a guarantee on a loan to a firm by covering a portion of the default risk of the loan. In the case of default by a firm, the lender recovers the value of the guarantee. The lender is also usually obligated to proceed with the collection of the loan and share the proceeds with the guarantor. Guarantees are usually provided for a fee covered by the firm, the lender, or both.

PCGSs, typically operated by an independent company, a development finance institution, or a government agency, are used to alleviate the constraints facing SMEs in accessing finance.¹ Lenders are usually reluctant to extend credit to firms that do not have the necessary amount and type of assets that could serve as collateral for the loan. Moreover, SMEs, especially small and young companies, have a limited credit history and opaque financial statements. Sometimes, they are unable to prepare bankable business plans. As a result, many SMEs with economically viable projects cannot obtain the necessary financing from the formal financial sector.

In use by many countries since the beginning of the twentieth century, PCGSs experienced unprecedented growth in the aftermath of the 2007–09 global financial crisis, when they were widely embraced to stimulate the flow of countercyclical finance to small businesses. Thanks in part to that experience, during the COVID-19 (coronavirus)

crisis more than 40 countries, especially advanced economies and emerging markets, relied on PCGSs to support firms' financing needs arising from pandemic-induced shocks.²

The expansion of PCGSs triggered demand for good practices in their design, execution, and evaluation. An effective, efficient PCGS is one that maximizes outreach (the number of firms served) and additionality (among other things, its intended outcomes in terms of additional credit mobilized, improved terms and conditions, and jobs created), while maintaining financial sustainability. Against this background, in 2015 the World Bank, in partnership with international associations of PCGSs and lenders and with the support of the FIRST Initiative, developed a set of high-level principles to guide the operations of PCGSs.³

The principles recommend adoption of a set of legal, regulatory, governance, and risk management arrangements. They also include operational conduct rules for PCGSs, which are expected to

lead to better outcomes for beneficiary firms. The principles draw from the sound practices of PCGSs implemented in jurisdictions such as Chile and the European Union. The principles are also aligned with the practices of those PCGSs whose financial and economic impacts have been positively evaluated.⁴ Although the principles have been widely adopted across countries, some gaps remain.⁵

The unprecedented economic distress caused by the pandemic and the need to act swiftly to preserve economic stability have necessitated in many cases a departure from the principles, especially those on the legal and institutional framework, risk-sharing, and pricing. Although the vast majority of jurisdictions already had a legal and institutional framework in place to issue guarantees, especially in Europe, Latin America, and parts of Asia, changes have been made to adapt PCGSs to the unique circumstances created by the pandemic, such as in Colombia. Some credit guarantee programs have been used to target specific sectors or marginalized communities for credit. For example, Burkina Faso has a specific program that targets small businesses owned by women. In some countries such as South Africa that had no PCGS, it has been established. There have also been adjustments to credit guarantee schemes, such as extensions to loan tenors so borrowers have more time to make payments and increases in the coverage ratio of the guarantee to expand eligibility. However, some countries such as Argentina have raised the coverage rate of the guarantee up to 100 percent, especially for the most vulnerable borrowers, thereby increasing the risk of moral hazard. In several cases (such as in Italy), fees have been capped or waived altogether, decoupling pricing from risk.

These design features of PCGSs have involved difficult trade-offs, with important implications for the reach of the guarantee programs, the risk of “zombification” of economies, the size and type of the contingent liability for governments, and the impacts on financial sectors.⁶ Although in the midst of a pandemic PCGSs should ideally target viable but temporarily illiquid firms, in practice distinguishing viable from unviable businesses is difficult, especially when information is

scarce. In view of the massive uncertainty, many governments have opted instead to include large segments of sectors and firms. This strategy has ensured wider reach and speed, but it will have unintended consequences for long-term growth if it ends up zombifying parts of the economy, especially where complemented by loan moratoria and where zombie firms were proliferating even before the pandemic.⁷

The design of a PCGS also has a bearing on the fiscal risk assumed by a government. The state bears a contingent liability in all countries, and yet the type of exposure may depend not only on the size of the scheme but also on how it is implemented.⁸ The contingent liability is direct when the guarantees are issued and administered by the central government, such as in Belgium, and indirect when the guarantees are channeled through public independent entities, such as in Morocco. In some cases, the contingent liability is supplemented by funds channeled to the public financial institution, such as in Chile. Finally, PCGS design features can impose costs on the financial sector. Loose credit requirements and ultra-low interest rates may eventually propel a rise in nonperforming loans once moratoria and suspension of classification criteria are lifted.

It is too early for an impact assessment of the unprecedented use of PCGSs in the context of the COVID-19 crisis, but several governments have promised robust ex post evaluations, especially because of suspicions of significant fraud.⁹ Yet some preliminary conclusions are emerging: at least in the European context, where PCGSs have been designed without too much consideration for fiscal capacity, use of the schemes was positively correlated with the drop in economic activity, and demand for guarantees plateaued in mid-2020 after an initial burst.¹⁰ As economies have entered the rebound if not recovery phase, the challenge for governments will be to shift their focus from protection to reallocation of capital and labor in a context of high corporate leverage and more limited fiscal resources. In such an environment, PCGSs could still play an important role in facilitating the flow of finance to the productive sector,

and yet their design will have to adapt to that role to remain relevant and effective.

Countries relying on PCGSs will have to pursue at least three strategic and operational changes to support the process of resource reallocation.¹¹ First, because PCGSs will have to confront a wave of borrower defaults, at least in jurisdictions where the government has not directly underwritten the COVID-19-related risk, it may be necessary to maximize recovery for the exposures to nonviable firms and to convert into equity or quasi-equity instruments the exposures to viable businesses. Second, PCGSs will have to return to “normal” to minimize moral hazard, phasing out the exceptional design features implemented during the COVID-19 crisis. Such a return implies adopting the highest standards of risk management and more targeted eligibility criteria. It also implies developing new products such as equity guarantees to help firms rebalance their capital structure. Finally, PCGSs could play a pivotal role in redirecting financial flows toward low-carbon activities, thereby supporting the green recovery. That would imply a redesign of PCGSs’ mandate, corporate governance and risk management framework, eligibility criteria, and product range.

Notes

1. Credit guarantee schemes can also be private, and in many economies they are run by private companies, cooperatives, or consortia of firms. However, they are often financially supported, directly or indirectly, by the public sector.
2. OECD (2021).
3. World Bank and FIRST Initiative (2015).
4. See OECD (2016) for a review of the literature.
5. Calice (2016).
6. Anderson, Papadia, and Véron (2021).
7. Banerjee and Hofmann (2020).
8. Emre et al. (2020).
9. Thomas and Morris (2020).
10. Anderson, Papadia, and Véron (2021).
11. Calice (2021).

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