Official Guarantees for Lending to Small & Medium Enterprises

John K. Thompson, Senior Fellow
Boston Institute for Developing Economies

November 18, 2010
Rationale for Programs

• Most OECD Countries have guarantee programs for SME lending

• (A “niche product”; most SMEs do not use these programs)

• Justification for Guarantee Programs: Market Failure

• Many SMEs with sound economic and financial prospects cannot obtain credit.

• Sources of Market Failure
  – Transparency & disclosure
  – Monitoring
  – Risk/ Reward balance
Suppliers of Finance: Banks

• General Requirements
  – Strong legal protection of creditors
  – Transparent financial statements
  – Adequate information flows

• Receive fixed payments with low margins
  – Must have high probability of repayment (low loan loss ratio)

• Principal/Agent Conflict
  – Prefer low risk steady return project
  – Insist on risk sharing (equity, collateral)
  – Must be able to monitor borrowers
Distinctive Situation of SMEs

- High Rates of Entry and Exit
- Opacity
  - Asymmetric information
  - Limited applicability of financial statements
  - Strong Motivations to remain opaque: Taxes/Regulations/Bank Monitoring
- Near Identity of Entrepreneur & Firm
- Principal/Agent Conflict: The view of the firm
  - Control information flows
  - Shift as much risk as possible to bank
  - Keep the “upside”
How serious are the problems of SME lending?

• In many emerging markets SMEs have little access to formal banking system
  – (Opacity/principal agent problems/ weak legal systems/ lack of collateral/ monitoring/ disincentives to enter formal economy.)

• But, in most OECD countries “traditional” SMEs have largely mitigated market failure:
  – Creditor Protection/ information flows
  – Banking techniques (relationship banking, credit scoring)
  – Mutual Guarantee Societies (MGS)
  – Official Guarantee programmes
    • Enhanced Monitoring
    • Risk Sharing
Loan Guarantee Programmes

• Programs administered by specialized agencies
• Skilled in project selection
• Guarantee long-term investment not working capital
• Usually mandated to act as commercial entities, cover all expenses
• Risk sharing principle
  – Entrepreneur
  – Bank
  – Government
• Ceiling on guaranteed share
  – Typically about 50%; can go as high as 80%
  – Some agencies vary fees with risk
Emergency Assistance Programmes, 2008-10

- With Global Financial Crisis Market Failure Worsens
- Governments respond with emergency aid packages, 2008-09
  - Increased Amounts for Guarantee Funds/Capitalisation of Supporting Institutions
  - Maximum Percentage Guarantees Raised (up to 90-100%)
  - Special Facilities for Working Capital
  - Eligibility Criteria Eased
  - Later in 2009 and in 2010 Programmes Expand
    - Termination Dates Extended/Eligibility Criteria Further Eased
  - Currently debating phase-out of programs
Limits of Guarantees

• Best for “traditional” SMEs in conjunction with bank loans
• Less relevant for SMEs with “non-traditional” risk/reward profiles
  – Fast growing SMEs
  – Innovative SMEs
  – Technology-based SMEs
  – Most OECD countries have problems financing non-traditional SMEs
• Alternative financing techniques with appropriate risk/reward and monitoring structures
  – Equity/Subordinated debt
  – Venture capital
• Governments can still provide financial support, but other methods must be used