The role of CGS in enhancing financial inclusion

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Learning outcomes

- 1) to examine the constraints facing small businesses in accessing finance and discuss the role of banks
- 2) to understand the role of CGS in enhancing access to finance and provide some examples from Europe
- 3) to reflect on some of the challenges going forward

SMEs and the economy

- Small businesses are the **engine** of most economies
- Globally**, SMEs** account for **over 90%** of all businesses and **around 50%** of total employment (in Europe: over 99% and 2/3)
- In **emerging markets** most formal jobs (7 out of 10) are generated by SMEs.
- Addressing **access to finance** and the **financing shortages** problems of the small business sector is crucial as these affect their growth and development.
- **Banking sector** still main role: SMEs' most relevant financing sources are **bank-based instruments**.

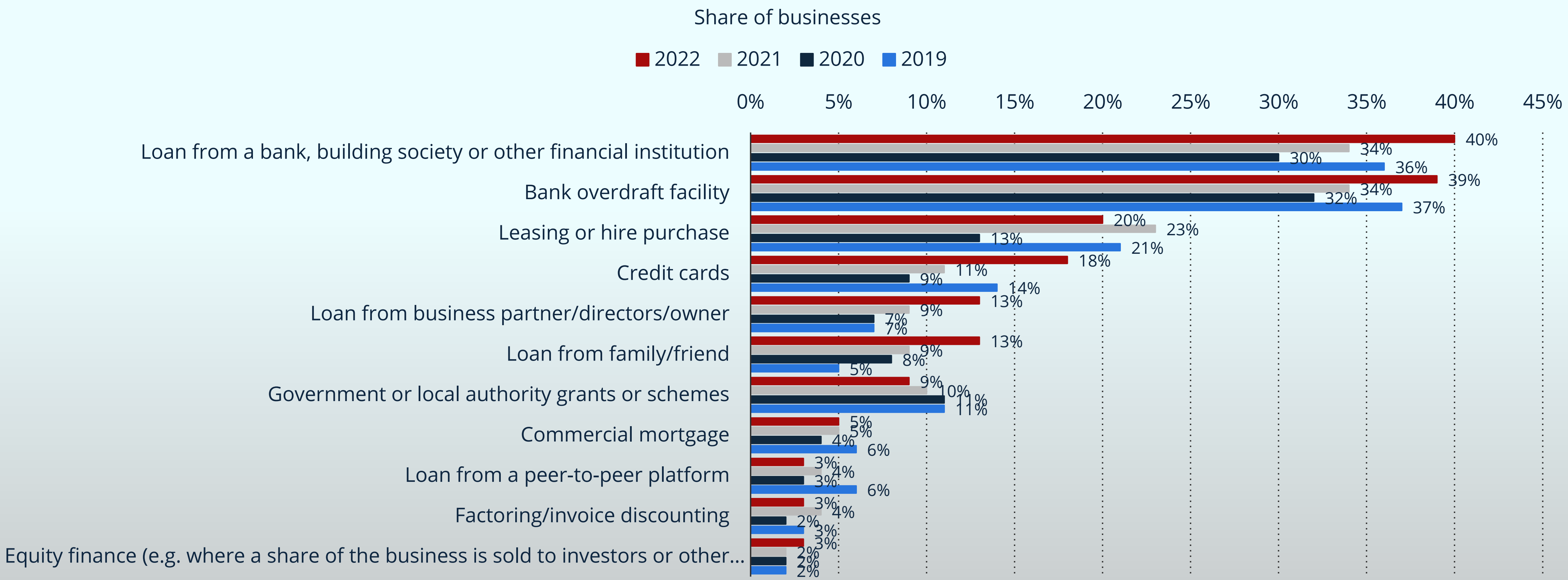
Financing gap

According to a study by IFC the SMEs' financing gap in developing countries is estimated at **$5.2 trillion every year**

In EU: **euros 176.7 bn** ($193.76 bn) according to FI Compass (2019)

Types of external finance applied for business according to small and medium enterprises in the United Kingdom (UK) from 2019 to 2022

External finance types sought by small and medium enterprises in the UK 2019-2022



Description: In 2022, the most used type of external finance sought by small and medium enterprises (SMEs) in the United Kingdom was loan from bank, building society or other financial institution. Approximately 40 percent of SMEs had applied for external finance via a bank overdraft facility in the previous 12 months. Again a further 39 percent of SMEs had applied for a bank loan from a bank overdraft facility in the last 12 months. Read more
Note(s): United Kingdom; 2019 and 2022; Small businesses with employees
Source(s): GOV.UK

SMEs and banks: constraints

Do not publish detailed financial statements
Inadequate credit history (either limited or non existent)
Limited significant assets that can be used as collateral

RISKS AND COSTS
Perceived as higher risks compared to larger and more established businesses
More costly (hence, lower returns) due to the need for more detailed risk assessment and monitoring

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- High NPLs
- Bank regulation
- Less stable funding base
- High market power/ market share

- Higher premiums for SMEs
- Tend to be even higher in crisis time

What are CGS?

- Credit guarantee schemes (CGSs) can be defined as **any financial arrangement or programme** designed to facilitate and encourage lending by providing an effective guarantee to lenders (these can be banks, or other financial firms). The guarantee can be full or partial
- Main parties to the CGS
  - 1) **borrower** that has no or limited collateral
  - 2) **lender** providing loan or overdraft (eg a bank) that assesses the creditworthiness of borrowers
  - 3) **guarantor** providing the guarantee (can be the government)

Role of CGS

- Well-designed and well-priced credit guarantees help close the financing gap **by substituting collateral provided by a borrower with credit protection provided by an external guarantor**.
- Two points
  - 1) external guarantees and collateral are often used side-by-side on the same loan
  - 2) to be successful, guarantees need to generate additional lending, that is the main policy aim

Public and private CGSs

- Public CGSs – where funding is provided by the public sector – usually arise from policy initiatives to improve the access to finance for SMEs. **Public schemes are the most prevalent type in emerging economies.**
- In many **developed economies** private CGSs also exist. These are typically **mutual guarantee schemes**, based on industry associations, where members jointly provide guarantees on the loans taken by the individual members.
  - Although the guarantee schemes are mainly operated by private mutual associations the government is still involved.

CGS in Italy: FSG and Confidi

- The **Italian public guarantee scheme** is called "*Fondo Centrale di Garanzia*". The Fund acts as a guarantor, committing itself to repay the loan to the lender, if the borrower defaults.
- It can involve also a fourth agent, typically a Mutual Guarantee Institution (MGI, Italian *Confidi*) that are cooperative, non-profit credit guarantee consortia where SMEs are members, contribute to a syndicated fund and create a collective collateral.
- Firms eligible for the guarantee are SMEs that have passed an assessment of **financial soundness (a scoring system)**
- The **application process** for the guarantee may be initiated by the firm, asking the bank to apply for the FCG when requesting a loan. It may also be the bank itself that suggests it.
- The public guarantee covers **up to 80% of the loan value** and cannot exceed the maximum of 2.5 million euros.
- After providing the public guarantee, the FCG **applies a fee** ranging from 0 to 3% of the guaranteed amount of loan

CGS in Italy: benefits for banks

- The public guarantee is eligible for **credit risk mitigation under the Capital Requirement Regulation**.
- This is a key point for banks, because it relieves them of regulatory capital requirements.

  → The government commitment of acting as a LLR reduces the capital requirement for the guaranteed share of loan to zero!
- As a result, banks are able to grant loans at better conditions, increasing the amount of loan and/or reducing the cost

https://www.bancaditalia.it/pubblicazioni/temi-discussione/2020/2020-1265/en_Tema_1265.pdf

CGS in UK: the EFG and the British Business Bank (1/2)

http://british-business-bank.co.uk

- Loan guarantee schemes in the UK originated **in 1981** and has been used consistently as a public policy instrument
- Within the overall provision there has always been **exceptional provision** during crises (eg GFC, Covid)
- Three parties involved:
  - 1) the borrower (the credit constrained firm)
  - 2) the lender (the bank)
  - 3) the UK government agent (the British Business Bank) that manages the Enterprise Finance Guarantee

CGS in UK: the EFG and the British Business Bank (1/2)

- Since its launch in 2009, the British Business Bank's Enterprise Finance Guarantee (EFG) has supported the provision of over £3.3bn of finance to more than 35,000 smaller businesses in the UK
- EFG guarantees loans to fund the future growth or expansion of a business, from £1,000 to £1.2 million.

- https://www.british-business-bank.co.uk/ourpartners/supporting-business-loans-enterprise-finance-guarantee/about-efg/

Added value of credit guarantee schemes for SMEs

• **Improves access to finance** for economically viable projects and at better conditions
• Fosters a **more inclusive financial ecosystem** and **improves financial inclusion** especially when making credit more accessible to businesses 1) run by women and minorities 2) run in geographically underserved regions
• Contributes to the **growth of SMEs**, helps create jobs and fostering economic development
• Provides SMEs with **additional support** and expertise that helps reduce asymmetric information
• In mutual guarantees institutions SMEs participate in the management of the scheme
• **Helps building trust** between small businesses and banks / financial firms
• **Facilitates recovery** from recession/ crisis periods and increases resilience of small businesses in challenging periods

Added value of credit guarantee schemes: banks

• Increases lending activities
• Reduction in banks' risk exposure and improves quality of credit
• Guarantees can positively affect banks' regulatory requirements
• Contribution to bank SME/retail portfolio diversification
• In case of default, higher level of liquidity, compared to other types of collateral

Challenges going forward

- According to the World Bank **600 million jobs will be needed by 2030** to absorb the growing global workforce.
  - This means that for many governments around the world the **development of SMEs is a high priority**.
- New risks/ modern risks for small and medium firms…

Leading risks to mid-size and small companies globally for 2023

Leading risks to SMEs worldwide in 2023

	Mid-size companies	Small companies
Business interruption (incl. supply chain disruption)	34%	23%
Cyber incidents (e.g. cyber crime, malware/ransomware causing system downtime, data breaches, fines and penalties)	29%	31%
Macroeconomic developments (e.g. inflation, deflation, monetary policies, austerity programs)	23%	28%
Natural catastrophes (e.g. storm, flood, earthquake, wildfire, extreme weather events)	18%	15%
Climate change (e.g. physical, operational and financial risks as a result of global warming)	14%	15%
Energy crisis (e.g. supply shortage/outage, price fluctuations)	24%	23%
Changes in legislation and regulation (e.g. trade wars and tariffs, economic sanctions, protectionism, Euro-zone disintegration)	20%	20%

Note(s): Worldwide; October and November 2022; 2,712 respondents

Further information regarding this statistic can be found on Page 4.

Source(s): Allianz; ID 422207

Challenges going forward

- To increase financial access and financial inclusion, credit guarantees could target more certain **regions/ borrowers types** (→ be more inclusive) and maybe also prioritise sustainable businesses
- Also SMEs should depend less from banks
  - → SMEs would also benefit from a wider set of funding sources.

  (many are discouraged from applying too..)
  - → what about awareness of credit guarantees schemes

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Thank you!

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