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Sustainable Architecture for Finance in Europe (https://safe-frankfurt.de/)

SAFE Finance Blog

Are credit guarantee programs the right medicine for small businesses?

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Thomas Mosk: Policy makers should critically review their COVID-19 guarantee programs in order to avoid unintended side effects

The wide-spread lockdowns that followed the outbreak of COVID-19 are having a substantial impact on the economy, in particular on small and medium-sized enterprises (SMEs). SMEs are especially vulnerable for economic shocks because of the "underlying condition", that is their dependence on bank financing and related financial constraints. It is therefore not surprising that economists, politicians, and policymakers called for policies that support small businesses. A widespread policy response has been to initiate or amend existing credit guarantee programs. Nearly all countries (see below) put their guarantee program at the center of their strategy to alleviate SMEs financing problems. Although it is a seemingly efficient choice to use guarantee programs as policy choice because most countries could directly use the institutional framework of an existing guarantee program, it is not self-evident whether state guarantee programs are the

right medicine to cure distressed SMEs.

The role of credit guarantee programs in the COVID-19 crisis

The current economic crisis is unique in its kind because the crisis consists of at least two kinds of economic shocks: a shock to production due to the disrupted global supply chains and an unprecedented demand shock as a result of the lockdowns. This demand shock resulted for most small businesses in a sudden dry-up of cash flows and liquidity shortages. National governments directly responded to support SMEs with direct subsidies and short-term work compensations but also substantial expansions of guarantee programs. The table provides an overview of COVID-19 specific guarantee programs for eight countries. Common proposed changes are an expansion of the maximum guarantee, a higher guarantee coverage, wider eligibility and better terms and conditions. For example, Germany increased the maximum guarantee to 2.5 million euros per firm and increased the maximum guarantee for working capital to 80 percent. Although some empirical evidence shows that guarantee programs increase access to finance and helps newly created firms grow faster (Lelarge, et al., 2010 (http://faculty.haas.berkeley.edu/dsraer/text_NBER_final.pdf); Ioannidou, et al., 2018 (https://safe-frankfurt.de/publications/working-papers/details/publicationname/intended-and-unintended-consequences-of-government-credit-guarantee-programs.html)) less is known about unintended effects of guarantee programs. Thus, policy makers have to consider advantages and disadvantages of guarantee programs before using this policy instrument.

Overview COVID-19 Guarantee Programs in eight countries

CY	Covid Guarantee Program	Proposed Changes
UK	Coronavirus Business Interruption Loan Scheme, Bounce Back Loan Scheme	Expansion of maximum guarantee, higher guarantee coverage, wider eligibility, better terms and conditions
US	Express Bridge Loan Scheme, Economic Injury Disaster Loan, Paycheck Protection Program	Wider eligibility, better terms and conditions
Germany	Coronavirus Finanzierungslösung, Corona-Hilfen	Higher guarantee coverage, wider eligibility
France	Garantie bancaire du renforcement de la trésorerie Coronavirus	Higher guarantee coverage, wider eligibility, better terms and conditions
Spain	Líneas COVID-19	Expansion of maximum facility, higher guarantee coverage
Italy	Guarantee Fund for SMEs, and various regional schemes	Higher guarantee coverage, better terms and conditions
Netherlands	Guarantee scheme (BMKB)	Higher guarantee coverage, wider eligibility, better terms and conditions, more participating financial institutions
Portugal	Linha Específica Encerrada COVID-19	Expansion of maximum facility, higher guarantee coverage, better terms and conditions

Advantages of guarantee programs and potential unintended side effects

The main advantage of guarantee programs in the current crisis is that guarantee programs could rely on existing institutions. Almost every country could use the structures of the existing program to directly

implement COVID-specific changes. Since most firms initially faced short term liquidity shortages, any policy addressing these problems should have a short implementation time. Another advantage of guarantee programs is the familiarity of bank employees and entrepreneurs with the programs. Despite these advantages, guarantee programs could result in several unintended effects or conflicts with other regulation to govern the financial sector. Guarantee schemes could not only result in cross-border competitive distortions (https://www.bruegel.org/2020/07/government-guaranteed-bank-lending-beyond-the-headline-numbers/) but also a mismatch with the SME financing needs might result in over leveraging and bad bank incentives. Policy makers should therefore critically review their guarantee program. The list below contains an overview of these unintended effects and policy recommendations to address these problems.

- **Poor fit with SME financing needs in the COVID-crisis**
  Most guarantee programs are designed to stimulate small business investments in fixed assets rather than providing guarantees to cover short term liquidity needs. For example, some programs explicitly specify for which concrete purposes guarantee loans could be used or link guarantees to term loans, rather than credit lines, while firms often use credit lines to finance their short term liquidity needs. A guarantee program should therefore have a different design to address a sudden demand shock than a program to address a bank induced credit crunch. For example, the guarantee program should allow firms to use the guarantee to secure new credit lines and not restrict the use of guarantees to investments in tangible assets.
- **Excessive leveraging**
  Guarantees are always linked to debt instruments which ultimately increase the leverage ratio of the firms. High leverage increases the probability of (strategic) default due to high interest expenses and installment. In addition, high leverage ratios could create debt overhang problems in the long run reducing incentives of entrepreneurs to make investments. To prevent these problems governments should consider to complement guarantee programs with equity-type instruments (See for example the proposal of Boot, et al, 2020 (https://safe-frankfurt.de/fileadmin/user_upload/editor_common/Policy_Center/SAFE_Policy_Letter_79_final_with_cov
- **Guarantee programs might provide bad incentives to banks**
  Guarantee programs could result in an effect transfer of credit risk from the bank to the guarantee scheme. This risk transfer could reduce the incentives of banks to screen firms because they have at the end less skin in the game. Guarantee programs should therefore contain clear and verifiable screening guidelines for banks, which the responsible authority the guarantee agency could audit before a payout. In addition, in case of default banks might prefer to rather liquidate state guaranteed loans than renegotiate the terms with the firm to allow a reorganization. Liquidation costs of guarantees are low in comparison with the liquidation of commercial real estate or firm inventory. Since the liquidation of guarantee loans is quick and cheap, banks might prefer liquidation over debt restructuring. Firms that obtained a guarantee loan today might still be liquidated down the road. It is therefore important that guarantee programs do not pay out too quickly.

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Blog entries represent the personal views of the authors and not necessarily those of SAFE or its staff.

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