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Public guarantees for bank lending in response to the Covid-19 pandemic[1]

Highlights

- *In response to the Covid-19 pandemic, governments have launched guarantee programmes to support bank lending to companies, especially small and medium-sized enterprises. This is essential to avoid a sharp contraction in bank credit that would exacerbate the pandemic's adverse impact.*
- *The design of such programmes needs to strike a difficult balance between responding promptly to the pandemic and maintaining a sufficient level of prudence. Key features of a sample of programmes (eg target beneficiaries, coverage of the guarantee, loan terms, length of the programme) reflect this tension.*
- *Incentives were created for the banks to join these programmes by exploiting flexibility in existing prudential requirements, while central banks have often provided liquidity support. Programmes are, however, subject to operational challenges and, ultimately, fiscal capacity limits.*

1. Introduction

The adverse economic impact of the Covid-19 pandemic is acute and risks worsening. In order to provide liquidity to the economy, governments in several jurisdictions are offering guarantees on bank loans to non-financial companies. These are expected to encourage banks to continue providing credit, and to prevent an even deeper recession, as discussed in Section 2 of this note.

Section 3 reviews key features of a sample of guarantee programmes, illustrating approaches taken in response to a systemic crisis such as the current one and highlighting some of the differences between them. Section 4 reviews some complementary measures, and notes some of the key challenges.

2. Why bank guarantees

The economic contraction caused by the Covid-19 pandemic is already substantial. Uncertainty about when and how quickly economies will recover has generated concerns that the contraction will not only create liquidity strains for non-financial companies but also affect their viability more generally.

Under these conditions, companies' traditional source of credit – bank credit – is likely to dry up. Given heightened uncertainty about credit quality, banks can become extremely risk-averse. This can lead to a market failure that will exacerbate the crisis as, while each bank may restrict lending out of prudence, the cumulative effect will be excess credit rationing. This in turn can worsen the prospects of recovery.

National authorities have responded to this risk by reducing some bank capital requirements and have encouraged banks to draw down their buffers. At the global level, the move was supported by the

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Basel Committee on Banking Supervision (BCBS (2020a)),[2] the Financial Stability Board, the G7 and the G20. While this has given banks room to lend, it cannot fully overcome their concerns about credit quality.

Several governments have therefore launched programmes of public guarantees on bank loans, especially for small and medium-sized enterprises (SMEs).[3] The guarantees can preserve incentives for bank lending, and leverage banks' credit risk expertise. Fiscal balances are protected if beneficiaries remain solvent, and in the short term the fiscal impact is limited as the guarantees are only drawn down if a credit turns bad.[4] This strategy is not without risks, however, as the long-term viability of borrowers can now be hard to gauge, and fiscal space to support the guarantees may be limited in some cases.

3. Overview of measures

An effective guarantee programme requires that some key features be spelt out in advance. These include the specification of the conditions for eligibility, the identification of the target beneficiaries, setting coverage and pricing terms, and the lifespan of the programme. More stringent conditions (eg relatively low coverage, short lifetime of the programme, loan collateral requirements) can help limit risks for the guarantor, but may come at the cost of more limited accessibility to beneficiaries. This balance also needs to be assessed against the context in which the guarantees are provided. At times of systemic stress such as now, concerns about reaching out to beneficiaries promptly and commensurately, and resolving a crucial market failure, may take priority. A sample of loan guarantee programmes launched in the context of the Covid-19 pandemic highlights this trade-off (see Table 1 for selected features).

Concerning eligibility, all programmes in the sample require that companies be in good financial standing and have no non-performing loans as of a cutoff date just prior to the onset of the pandemic. This helps to exclude cases where solvency may be at risk irrespective of the pandemic. However, proof of direct losses due to Covid-19 is not a prerequisite in all programmes, partly for operational reasons, but also reflecting the severity of the economic contraction, which will affect most companies at some stage.

The target beneficiaries vary in the sample, but in every country there is a programme for SMEs, and in some also for larger companies. This suggests the high importance given to SMEs, possibly reflecting the high proportion of employment they support. Moreover, unlike SMEs, larger companies may be able to raise funds in capital markets, and the securities they issue may be eligible for central banks' liquidity facilities. In line with the importance attached to SMEs, programmes addressed to them face lighter operational requirements and benefit from higher coverage ratios of the guarantee. However, the latter may also reflect the fact that SME loans have higher default rates, even in non-crisis times.

Incentives for banks hinge upon the coverage of the guarantee and its price, while a coverage ratio below 100% incentivises banks to exercise due care in their credit risk assessment. Table 1 shows that in several cases this ratio is below 100%, albeit it may have nonetheless been increased in comparison to normal times. There is also a relatively high number of programmes with a coverage ratio of 100%, mostly for smaller loans. The higher ratios may reflect the desire to overcome banks' proportionally higher

[2] For instance, the countercyclical capital buffer (CCyB) was released in several economies, including Brazil, France, Germany, Hong Kong SAR, Switzerland and the United Kingdom. However, the CCyB was at zero in several cases at the start of the Covid-19 pandemic, and even non-zero CCyBs were not necessarily large. See Borio and Restoy (2020) for an overview of measures.

[3] The use of government guarantees to encourage lending to some underserved economic sectors, or SMEs, is not unusual. Honohan (2010) discusses the three types of market failure that guarantees can address outside crisis times: (i) information asymmetry; (ii) risk diversification; and (iii) regulatory arbitrage to give borrowers access to financial markets.

[4] This makes loan guarantees preferable to direct government lending, on top of the operational difficulties of such loans. Grants, an often quoted alternative to guarantees, would have immediate fiscal implications. Grants may also encourage moral hazard.

operational costs when dealing with smaller loans, but also the extreme urgency of the crisis situation. Some programmes even explicitly allow for loan forgiveness.[5] While a very high coverage ratio removes concerns for banks, it comes at the risk of moral hazard and possible fiscal costs later on.

Key features of selected bank guarantee programmes — Table 1

Jurisdiction[6]	Beneficiary	Coverage ratio/ maximum loan size	Closing date	Terms	Loan maturity
Australia *Coronavirus SME Guarantee Scheme*	SMEs	50%; AUD 250,000	30 Sep 2020	6-month interest holiday at the start; rates then vary by lender	Up to 3 years
Canada *(Export Development Canada (EDC) Loan Guarantee Program)*	All legal businesses,[7] irrespective of exporting status	80%; CAD 6.25m	Extended mandate for EDC to end-2021	n/a	1 year
Canada *Canada Emergency Business Account (CEBA)*	Small businesses[8] and non-profits	100%; CAD 40,000	n/a	0% interest rate, no fees or principal repayments until end-2022, then 5% interest rate	Up to 5 years
France (*Bpifrance)*	All types of company[9]	70–90% (higher for smaller firms); cap of 25% of 2019 revenue or two years of payrolls	31 Dec 2020	No payment in the first year; interest rate set by the bank, guarantee cost ranging over 25–200 bp	Can repay by end-2020, or extended by a maximum of 5 years
Germany *Bundesregelung Kleinbeihilfen 2020*	SMEs	100% for loans up to: EUR 500,000 for firms with 50 employees; EUR 800,000 for others[10]	31 Dec 2020	Loan rate to be determined for each company by the bank	n/a
Germany *(Kreditanstalt für Wiederaufbau (KfW*))	Companies of all sizes	90% for SMEs, 80% for others;[11] EUR 1bn per company	31 Dec 2020	Loan is subsidised (lower interest rate range for SMEs)	Up to 5 years

[5] Loan forgiveness is associated with meeting certain conditions, giving the beneficiary an incentive to reach the target set in the programme. For instance, in Canada's EDC Loan Guarantee Program, repaying the balance of the loan by the end of 2022 will trigger forgiveness of 25% of the loan. In the United States, a borrower of a Paycheck Protection Program (PPP) loan is eligible for loan forgiveness if the loan was used to cover payroll costs and for staff retention.

[6] When the guarantee is granted via a public development bank or fund, its name is provided in brackets.

[7] At launch, only SMEs fell within the scope of the EDC Loan Guarantee Program.

[8] The eligibility criteria were changed in April, eg the wage floor was lowered (to CAD 20,000) and its ceiling raised (to CAD 1.5m).

[9] The approval process is more straightforward for companies with up to 5,000 employees.

[10] In the March version of the programme, coverage was 80% for larger firms and 90% for others; rates were increased in April.

[11] Prior to the Covid-19 pandemic, KfW assumed no more than 50% of the financial risk of comparable loans.

Hong Kong SAR *Special Financing Guarantee Scheme (SFGS)*	SMEs	100%;[12] up to total amount of employee wages and rents for six months or HKD 4m	Available for 12 months	Optional principal moratorium for 1 year; rate is Prime Rate minus 2.5%; no guarantee fees	Up to 3 years
Italy *(Fondo di Garanzia PMI)*	SMEs	80–90%: loans up to EUR 1.5m[13] 100%: loans up to EUR 800,000[14]	17 Dec 2020	Guarantee cost waived; loan rates set by lenders	n/a
Italy *(Cassa Depositi e Prestiti)*	Companies of all sizes – SMEs must first apply for the SME plan	70–90%;[15] cap of 25% of 2019 revenues or twice payroll costs	31 Dec 2020	Loan rate to be determined for each company by the bank [16]	6 years
Spain *(Instituto de Credito Oficial)*	Any Spanish company[17]	60–80% (varies with company size and new/renewed loan); no explicit cap	End-Sep 2020	Guarantee fees of 20–120 bp (to be borne by the bank)	Up to 5 years
Switzerland	Companies with turnover below CHF 500m	100% up to CHF 500,000, 85% up to CHF 20m; cap of 10% of annual turnover and never above CHF 20m	30 July 2020	0% interest rate up to CHF 500,000; portion over CHF 500,000: 0.5%, plus a premium on the remaining 15% of the loan	Up to 5 years
United Kingdom *Coronavirus Business Interruption Loan Scheme (CBILS)*	SMEs	100% up to GBP 250,000, 80% above GBP 250,000; up to GBP 5m	n/a	Interest holiday in first 12 months;[18] guarantee fee waived, lenders pay a fee; loan terms set by each lender	Up to 6 years
USA *Paycheck Protection Program (PPP) – CARES Act*	SMEs	100% to end-2020;[19] up to the lesser of USD 10m or a payroll-based amount	20 June 2020	1% interest rate; optional interest payment holiday for first 6 months	2 years

Source: Publications by national authorities. This table reflect publicly available information as of 16 April 2020.

[12] In April, the SFGS was expanded, eg both the maximum loan size and the application period were doubled.

[13] The fund can guarantee 80% of loans up to EUR 5m, under terms and conditions that existed prior to the Covid-19 outbreak and that continue to hold (before the outbreak, the maximum loan size was EUR 2.5m).

[14] The 100% coverage for smaller loans was added in the April revisions to the programme. The revisions also envisages that, for loans up to EUR 25,000, the bank can grant the loan without prior confirmation from the fund.

[15] The guarantee rate is higher the smaller the company is. The programme also envisages a 100% guarantee for loans below EUR 25,000 without requiring a risk assessment of the loan, as well as for loans up to EUR 800,000 under additional conditions.

[16] The loan rate has an upper bound determined according to credit default swap values for banks and the Italian Republic (with five-year maturity), and an average of rates on public debt, published by the central bank.

[17] Fifty per cent of the first EUR 10bn tranche is reserved for loans to SMEs and the self-employed.

[18] The government also pays the first 12 months of interest and any arrangement fees charged by the lender.

[19] At the start of 2021, coverage will return to 75% (85%) for loans above USD 150,000 (up to USD 150,000).

Pricing conditions are less easily comparable across programmes, but in general the cost of the loan and of the guarantee (if any) is subsidised, while still attractive to the banks. In some cases the programme fixes the loan interest rate, in others this is determined by the lending bank, with in-between cases where rates are fixed for the first part of the life of the loan and can vary thereafter. Some programmes also offer interest payment holidays for the first months, reflecting the expectation that the brunt of the economic impact will materialise at the start of the programme. Some programmes envisage a waiver of the guarantee fee that would have applied under normal economic circumstances. Separately, some programmes treat new loans and renewal of pre-existing loans differently, offering a lower guarantee rate for the latter, presumably because the banks' incentives in continuing the business relationship is higher in this case.[20]

Under the assumption that the Covid-19 pandemic can affect firms' liquidity but not their viability, limits to both the lifespan of these programmes and the loans' duration are to be expected. In particular, a limited lifespan can avoid introducing distortions in the financial sector once conditions return to normal. In the sample, some programmes have no explicit end date yet, and they may remain available until the dedicated funds run out,[21] while for many of the programmes with an explicit end date this is the end of 2020. In a similar vein, the maturity of the loans is relatively short, although across the sample it varies from one to six years. The shorter the original maturity of the guaranteed loan, the more likely that it will address only the most pressing liquidity needs. In some cases, programmes explicitly state that the loans are available only for working capital purposes.[22]

Finally, the intensity and speed of the crisis required a high level of flexibility in the design of the guarantee programme, with some features becoming less stringent overt time. This was the case for the eligibility criteria,[23] the coverage ratio[24] and the programme's lifespan.[25] Some jurisdictions, such as Hong Kong, Italy, Switzerland and the United States, also increased the size of the programme.

4. Complementary measures and challenges

Loan guarantee programmes can benefit from complementary measures that increase their appeal to banks and their customers. While in normal circumstances these measures may not be needed, pressure to implement the Covid-19-related guarantee programmes rapidly and on a large scale has driven authorities to introduce such complementary measures. Some challenges, however, remain and can affect the overall success of the guarantee programmes.[26]

[20] In Spain, for non-SMEs the guarantee rate is 70% for new loans and 60% for refinancing (it is always 80% for SMEs).

[21] Depending on how effectively the programme disburses funds, this may occur very quickly. In the United States, the funds available for the programme described in Table 1 were exhausted by mid-April and replenished thereafter.

[22] At the opposite end of the spectrum are programmes that allow the use of public funds to recapitalise companies. For instance, Germany announced that the fund (Wirtschaftstabilisierungsfonds, Economic Stabilisation Fund (WSF)) it created as part of its response package would be allowed to participate in firms' recapitalisation. The WSF can also issue loan guarantees to firms meeting minimum size criteria.

[23] For instance, this is the case for both programmes in Canada, as well as the SFGS in Hong Kong.

[24] This was the case in, for instance, Germany and Italy. This may have also reflected a softening of the conditions set by the European Commission. This happened first in March, via a communication introducing some common requirements for state guarantees in the context of the Covid-19 emergency and exceptions from State Aid Rules, and again in April.

[25] For example, in Hong Kong's SFGS, this was increased from six to 12 months.

[26] As discussed in OECD (2017), ex post evaluations of guarantee programmes are not frequent. In the current circumstances, success can be narrowly interpreted in terms of fund availability for the target beneficiaries without impairing banks' resilience.

Central bank funding

Banks need funding to provide the additional credit envisaged by the guarantee programme, especially if the new loans are expected to be granted quickly and in large amounts. To that end, several central banks have extended their collateral pools, and included credit claims issued under the guarantee programmes (eg the ECB). They have also created new, temporary standing facilities (eg Switzerland, or the United States for PPP loans), which allow liquidity to be drawn against credit claims issued under the guarantee programmes.[27]

A bolder approach has been adopted in the United States, with a new programme under which the central bank funds a special purpose vehicle that acquires loans from banks, at par value (see Box 1).

Box1

A hybrid programme – the Main Street Business Lending Program in the United States

As part of the CARES Act, the Federal Reserve announced the establishment of the Main Street Business Lending Program (MSLP), complementing the PPP covered in Table 1. As an emergency loan programme to support lending to SMEs, the MSLP is similar to loan guarantee programmes in some respects, but in others it is rather unique.

In the MSLP, the Treasury will make a USD 75bn equity investment in a special purpose vehicle (SPV), established by the Federal Reserve. The Fed lends to the SPV on a recourse basis, providing leverage that is expected to result in up to USD 600bn in loans. The SPV will purchase, at par value, 95% participations in these loans from the banks. Operationally, the MSLP will consist of two facilities. One, for unsecured loans; the other, the Main Street Expanded Loan Facility (MSELF), for "add-on" loans under existing loan facilities. Contrary to PPP loans, MSLP loans are not forgivable. The MSLP is also different from liquidity programmes for larger companies, where the Federal Reserve buys higher-rated corporate bonds.

Under the MSLP, banks benefit from a 95% guarantee of the par value of the loan. For the Treasury, losses are capped at USD 75bn. For the Federal Reserve, risk would be mitigated by collateral, under the MSELF and if collateral was attached to the original loan.

Accounting, disclosure and prudential treatment

The regulatory treatment of guaranteed loans directly affects banks' incentives to offer them. The BCBS clarified that the capital requirement for these loans should be aligned with that of the corresponding sovereign, as the latter guarantees the loans (BCBS (2020b)). This risk assessment implies a low capital charge for banks.[28] The BCBS also clarified that the fact the loans benefit from public guarantees should not automatically lead them to being categorised as forborne (BCBS (2020b)).[29]

On the accounting side, a crucial decision concerns the calculation of expected credit losses, given their impact on the profit and loss statement of banks. The provision of public guarantees can reduce the level of provisions that banks may otherwise have to make, particularly when the guarantee coverage ratio

[27] Central banks also activated programmes directly aimed at providing liquidity to the larger non-financial companies, irrespective of guarantee programmes – for instance, the Covid Corporate Financing Facility (CCFF) at the Bank of England and the Commercial Paper Funding Facility at the Federal Reserve, both of them for commercial paper.

[28] Some jurisdictions have taken additional regulatory measures. For instance, the US agencies decided that PPP-eligible loans will not be included in a bank's leverage ratio requirement if they are pledged as collateral to the PPP-dedicated facility at the central bank. See Zamil (2020) for an in-depth discussion of accounting issues in the context of the Covid-19 pandemic.

[29] Borio and Restoy (2020) show how authorities have provided additional guidance on asset classification.

is at 100%. For countries applying International Financial Reporting Standards, the International Accounting Standards Board stressed that disclosure can provide essential transparency to users of financial statements.[30]

Operationalisation challenges

Granting the guaranteed loans requires that a number of practical steps are taken. Implementing acts are necessary for the banks to price the loans correctly, select eligible companies and meet due diligence requirements. Importantly, banks need to be sure of the loan requirements that make these contracts eligible for the government guarantees; otherwise, they would bear the credit risk themselves, in full. For their part, companies also need clarity about the application procedure. Finally, where central banks have activated corresponding liquidity programmes, their terms must mirror those of the matching guarantee programmes to avoid some loans turning out to be ineligible.

In addition, limits in operational capacity of both banks and agencies issuing the guarantees can create bottlenecks. Such constraints will be tested by the high number of applications banks and agencies are likely to receive. Speed will also be of the essence, as these programmes have a finite budget, and applicants are under severe liquidity pressure.

Limits in fiscal backstops

The success of the guarantee programme also hinges on the size of the fiscal backstop in each country. Countries in better fiscal condition at the onset of the crisis can offer larger guarantee programmes, as a proportion of their economy, facilitating the recovery once the emergency is over. Moreover, as some of the guaranteed loans will inevitably fail to perform, public funds will have to be disbursed.

Any doubt about a country's fiscal capacity to absorb losses on guaranteed loans could damage the profitability or even the viability of banks, possibly engulfing them in a negative bank-sovereign loop.

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[30] For instance, the Swiss Financial Supervisory Authority FINMA requires separate reporting of the loan's part covered by the guarantee.