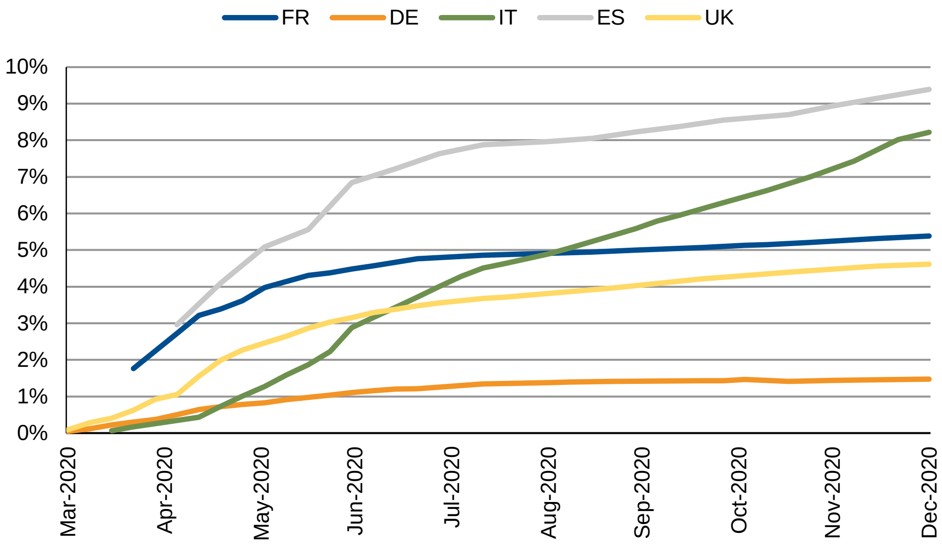
Sovereign incentives to honour government guarantees and their structured finance implications

Credit guarantee schemes (CGS) have long been used in many countries to alleviate the constraints facing small and medium-sized enterprises (SMEs) in accessing finance. In this report, we outline the motivations underpinning the use of such schemes, provide an overview of recently implemented measures by major European governments, and explore analytical key factors that we consider in our assessments of credit products that have governments as the ultimate guarantors.

CGS have played a key role in supporting SME access to financing in Europe since the early 20th century, alleviating typical credit constraints faced by smaller firms. More recently, many governments have launched large-scale public guarantee schemes to address SME funding gaps due to the Covid-19 crisis (**Figure 1**). The ability and willingness of governments to honour guaranteed debt obligations are essential inputs into our analysis of structured credit products that have governments as ultimate guarantors. This report considers the various drivers of sovereign incentives to honour such obligations, providing a framework to underpin our analysis.

Figure 1. Government-backed credit support to businesses (since Covid-19 crisis)
% of 2019 GDP



N.B. Amounts shown for the UK include public bond-buying under the corporate debt purchase programme.
Source: Bruegel, Scope Ratings GmbH

This paper highlights the following key take-aways:

- Risk-sharing agreements, borrower eligibility criteria and pricing of guarantees are essential parameters of credit guarantee schemes.
- Sovereigns are likely to honour guarantees even in times of financial distress. Still, treatment between different guaranteed obligations in highly stressed cases can depend on multiple factors, including the degree of spillover risks via the sovereign-corporate-banking nexus and contractual aspects.
- Consideration of public guarantees in structured finance analyses includes the sovereign rating but is also driven by an analysis of the legal framework and operational features of the guarantee mechanism, on top of the guarantor's incentives and ability to honour its obligations.

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Introduction to credit guarantee schemes

Easing access to financing for SMEs

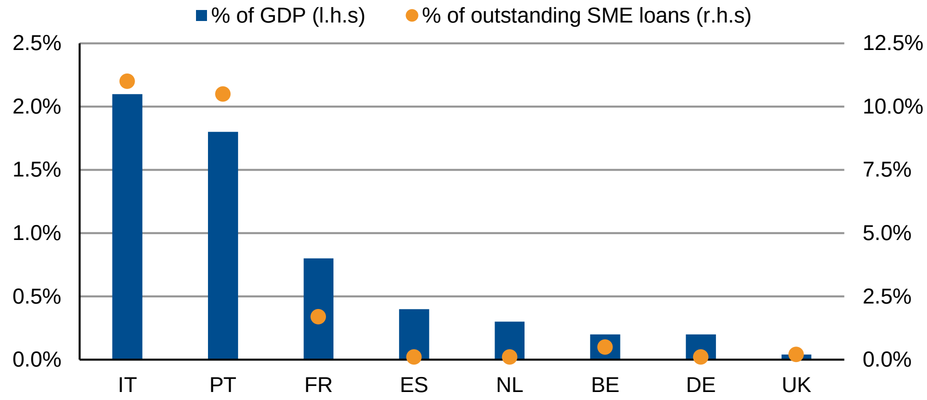
Credit guarantee schemes have been used in many countries as important tools to ease access to financing for businesses. They alleviate the credit constraints faced by smaller firms (lack of collateral, moderate capital buffers, short track record, recent establishment), while providing third-party credit-risk mitigation and capital relief to lenders, with a portion of potential losses upon default being absorbed by the guarantor. They have typically been mobilised to support credit flows to SMEs, which are the most affected by financing gaps[1]. A study carried out by the European Investment Bank (EIB)[2] shows that over 90% of institutions engaged in guarantee activities claim their associated programmes are explicitly and specifically targeting SMEs. More than half of all countries in the world have CGS for SMEs; this number is growing[3].

The most prevalent types of programmes are established within the public sector, with national governments acting as ultimate guarantors. Supranational institutions also provide guarantees to support investment projects as part of dedicated initiatives, offering numerous additional benefits, both to member States and to lenders. CGS can also operate through private initiatives, as they conceptually relate to credit insurance products typically set up for partial risk transfer, while also taking the form of risk-sharing agreements via mutual guarantee schemes.

An essential through-the-cycle public policy tool

Public CGS have historically played a key role in supporting SME financing in emerging and developed economies. Western European initiatives emerged in the early 20th century and have been used both as a policy response tool in economic crises and as an ongoing support mechanism, fostering the financial infrastructure to support the development of strategic sectors. Over two million guarantee contracts were outstanding across western Europe as of 2015, representing total value of EUR 68bn[4]. Credit guarantees are the most prevalent in Italy, Portugal and France, comparing the volume of their economic activity with outstanding SME loans (**Figure 2**).

Figure 2. Outstanding volume of credit guarantees in Western Europe
% of GDP; % of outstanding business loans granted to SMEs (r.h.s.)



N.B. Based on 2018 data.
Source: European Association of Guarantee Institutions, Eurostat, EIB, OECD, Scope Ratings GmbH

Providing support to the real economy…

From an economic perspective, public loan guarantees constitute an effective policy tool to increase credit supply to the real economy and address a lack of collateral required to benefit from favourable interest rates or bridge liquidity gaps. By assuming part (or all) of

[1] This is exacerbated in developing countries where the International Finance Corporation estimates that 65m SMEs have unmet financing needs of EUR 5tn/year
[2] EIB / European Investment Fund (EIF) (2017), Credit Guarantee Schemes for SME lending in Western Europe.
[3] The World Bank (2015), Principles for public credit guarantees schemes for SMEs.
[4] EIB / EIF (2017), Credit Guarantee Schemes for SME lending in Western Europe.

the credit risk, governments encourage lending by banks and reduce insolvency risks for otherwise financially viable firms.

This in turn preserves the productive capacity of the economy by avoiding large-scale bankruptcies and reduces the risk of adverse knock-on effects for labour markets, which is critical for sound post-crisis economic recovery. Empirical studies on the economic benefits of credit guarantee schemes in Europe have found a positive impact on employment, SME sector growth rates and company survival rates[5].

… and limiting the impact on public finances.

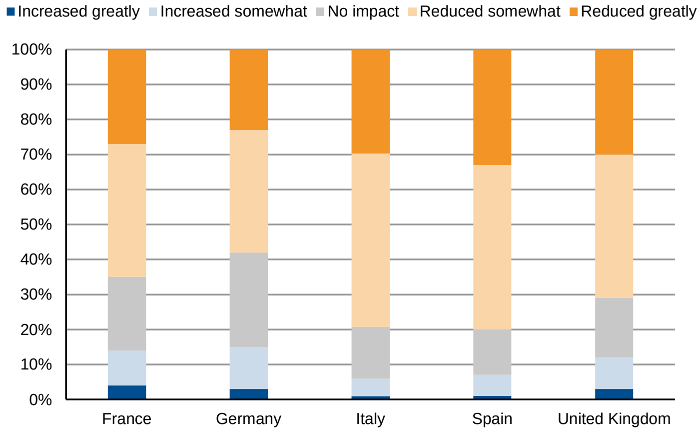
From a public finance perspective, government loan guarantees constitute a cost-effective policy tool to address the SME financing gap. In contrast to direct fiscal support through subsidised loans and grants, credit guarantees limit the immediate burden on public finances as their fiscal cost only materialises if the borrower fails to meet debt repayments.

Guarantee schemes: a key component of governments' response to the Covid-19 crisis

Public guarantees as a critical Covid-19 policy response tool

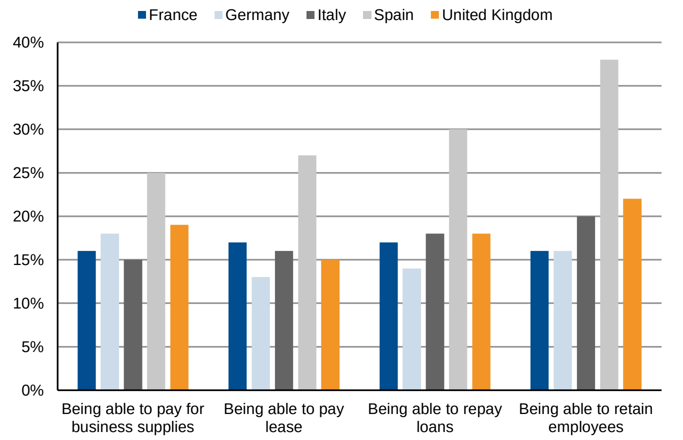
Loan guarantees have been one of the main instruments used by European governments to support domestic businesses and mitigate the immediate impact of the Covid-19 crisis on their economies. The onset of the Covid-19 crisis and the subsequent lockdown measures resulted in unprecedented revenue losses and cash flow pressure (**Figure 3**) on SMEs, severely impacting their financial positions and challenging their ability to retain staff and/or meet financial obligations (**Figure 4**). Several countries ramped up State CGS to help businesses access financing on favourable terms.

Figure 3. Covid-related changes in SME revenues
% of survey respondents



N.B. Based on surveys conducted in August 2020
Source: McKinsey & Company, Scope Ratings GmbH

Figure 4. SMEs' concerns about basic business operation
% of survey respondents



N.B. Based on surveys conducted in August 2020
Source: McKinsey & Company, Scope Ratings GmbH

Multiple State guarantee programmes

Most countries have come up with more than one State guarantee programme since the start of this crisis, including industry-specific guarantee funds aimed at spurring economic recoveries for sectors most affected by the pandemic. In the UK, for instance, the BBLS, CBILS and CLBILS[6] initiatives were successively implemented, each directed towards a specific universe of businesses. These schemes recently expired to make room for a single programme: the Recovery Loan Scheme, which is planned to be in effect up until the end of the year at the minimum. **Figure 5** provides an overview of schemes set up in the larger European countries since the start of this crisis.

[5] See Brault & Signore (2020), Credit Guarantees in the Covid-19 crisis – Relevance and Economic Impact, SUERF Policy Note.
[6] Bounce Back Loan Scheme, Coronavirus Business Interruption Loan Scheme, Coronavirus Large Business Interruption Loan Scheme, respectively

Figure 5. Overview of main CGSs across Western Europe, following Covid-19

	Italy	France	Germany	Spain	UK
Max. loan amount	EUR 5m for all borrowers	Three months of revenue or two years of total payroll value for younger firms	25% of 2019 revenue or 2x total payroll value	Not specified	25% of 2019 revenue, up to EUR 5m
Eligibility criteria	Must not be unlikely to pay pre-Covid; min. rating requirement	No missed instalments pre-Covid	Private companies, which must not be in financial distress as of 19 December	No missed instalments pre-Covid; no cash due to public admin	Private companies, which must not be in financial distress as of 19 December
Lender constraints	Periodic reporting to SACE	Fixed interest rates	Fixed interest rates	Capped fees and interest	Keep the risk of the loan on its balance sheet
Guaranteed amount	70 – 100%	70 – 90%	80 – 100%	60 – 80%	80%
Guarantee operator	SACE / Mediocredito Centrale	Bpifrance	Kreditanstalt für Wiederaufbau	Instituto de Crédito Oficial	British Business Bank
Guarantee fees paid by	Borrower	Lender during the 1st year, borrower from then on	Borrower	Lender	Lender

Understanding the guarantee structure

Wide range of loan characteristics

Standard CGS in western Europe typically provide guarantees on single products rather than on a portfolio basis[7], with some differences across programmes in terms of loan types (usually investment loans and working capital loans). Key characteristics such as maturity and amortisation type also vary, while net interest rates are supposedly lower than for non-guaranteed products.

Determining an adequate fee structure has proven to be challenging for CGS, as pricing is an essential part of the guarantee design, impacting the behaviour and incentives of various parties. Fees are typically based on loan size and can be charged upfront or annually, most often to the borrower instead of the lender. Empirical studies have shown that optimal fee structures should consider an SME's creditworthiness and the present macroeconomic state together[8].

Multiple eligibility criteria and borrower constraints

Loans benefiting from public guarantees feature numerous requirements for both lenders, and, most importantly, borrowers. Standard schemes include eligibility criteria on the characteristics of SMEs (size, time since establishment, minimum credit rating, maximum leverage, etc.), on the loan facilities (maximum amount, currency denomination, etc.), as well as the use of proceeds and future commitments (e.g. dividend distribution, borrower relocation, etc.). These eligibility criteria can also constrain the effective and timely flow of credit, which can be critical during an economic downturn. In the case of exceptional support packages, such as those implemented during the Covid-19 crisis, more rapid implementation could have been achieved with looser eligibility criteria and softer borrower constraints at the expense of higher underlying credit risk.

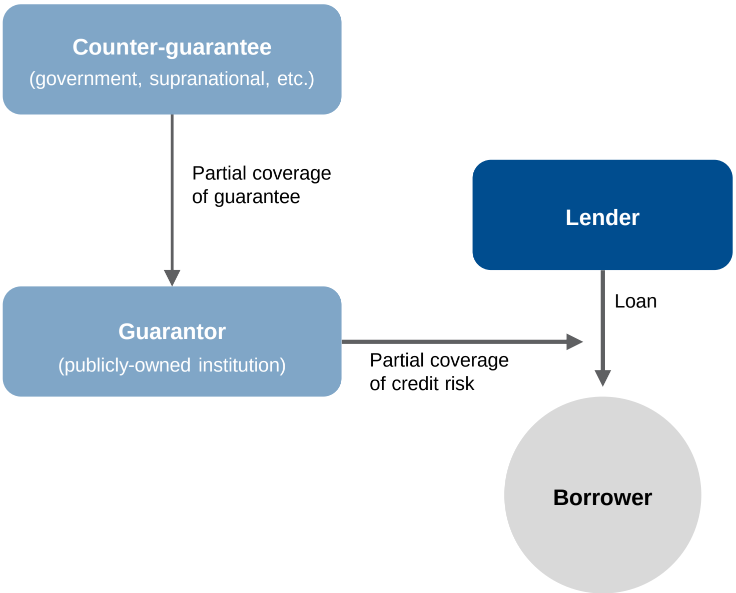
Ultimate guarantor of national public CGS is often the sovereign

An essential layer of domestic public credit-guaranteed schemes is the relationship between the operator and the guarantor. State-guaranteed programmes are typically either directly run by an administrative unit of the national government or by a legally separate credit guarantee organisation acting on behalf of the government.

[7] One counterexample is a recently launched French state guarantee programme under the Décret 2021-318.
[8] Taghizadeh-Hesary, Yoshino & Fukuda, A model for calculating the optimal credit guarantee fee for small and medium-sized enterprises, 2019.

In some cases, the entity managing the scheme also directly guarantees the relevant credit products, while benefiting from a counter-guarantee from the government; the latter thus acting as the ultimate guarantor **(Figure 6)**.

Figure 6. Simplified guarantee and counter-guarantee mechanism



Risk-sharing agreements are essential to reducing moral hazard risk

Risk-sharing agreements generally support the due diligence process and are essential to mitigating moral hazard risks, especially if a substantial portion of credit risk is assumed by the guarantor. Meanwhile, a lower guaranteed amount could discourage banks from participating in programmes. When applied on a loan-by-loan basis, guarantee coverage rates typically range from 50% to 90% of outstanding principal, depending on the terms of the relevant scheme.

In the case of schemes implemented at the portfolio level, the burden of SME defaults is typically fully covered by a guarantee fund, up to a pre-determined level of losses. The presence of a partial guarantee does not preclude the presence of partial collateralisation, as the latter could support economic recovery. In the case of default, the lender oversees servicing, whilst being required to share default recoveries stemming from additional collateral with the guarantor.

Lenders under guarantee schemes, banks or funds and often represented by their servicers, are typically entitled to call the guarantee following a pre-determined credit event. The latter typically includes breaches of payments, loan restructurings, or the start of a judicial procedure against a borrower. Indemnification generally occurs within 30 to 90 days following the claim, subject to the specific conditions in effect.

Dedicated legal structure

Credit guarantee institutions should have a distinct legal structure and are typically established as tax-exempt private corporations, even while being publicly owned. Legal obligations are outlined in standard bilateral contracts, which are considered to be binding agreements for the lender and the guarantor.

In the EU, credit guarantee schemes, and notably their capacity to provide capital relief for banks, are regulated by CRD IV/CRR legislation. A set of conditions should be fulfilled with regards to i) the terms of the relevant credit protection mechanisms; ii) the nature of the guarantor and the operator; and iii) the enforceability and effectiveness of the legal framework.

Sovereign incentives to prioritise different obligations

A distressed sovereign must consider the trade-offs relating to its different obligations

When a sovereign borrower is under financial distress, decisions to honour its different types of obligations (financial and/or social) will generally balance the trade-offs between preserving market access, ensuring continued provision of key public services, limiting damage to the domestic economy and avoiding politically costly decisions that adversely impact residents to the largest extent possible.

Direct debt vs guaranteed debt

Failure to honour irrevocable and unconditional guarantees is considered a default

Intuitively, one would think that a sovereign would prioritise its direct debt obligations over guaranteed debt. However, according to our Sovereign Methodology, the definition of a sovereign default also includes “missed coupon or principal repayment on non-sovereign debt benefiting from an irrevocable and unconditional guarantee issued by the sovereign”.

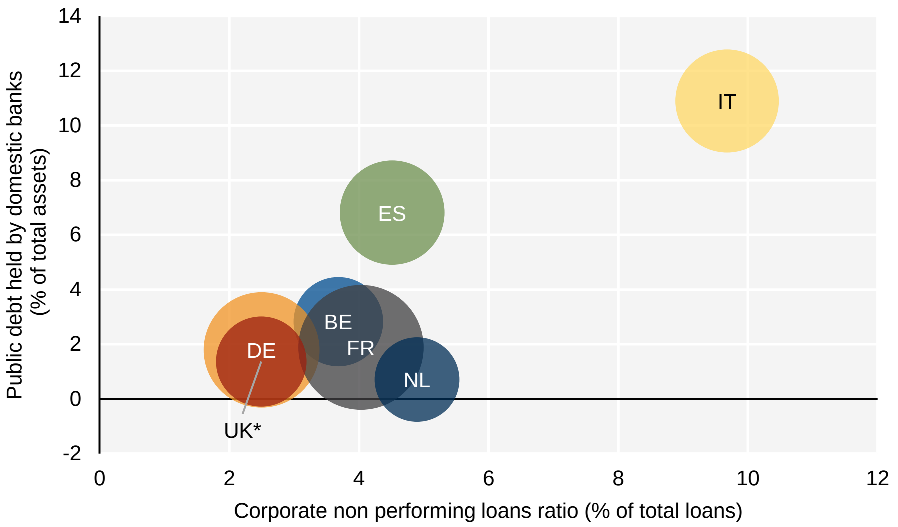
If a sovereign were to default on such guarantees, we would consider that to be equivalent to a default on its direct debt and would subsequently downgrade the country to “default” or “selective default” status. The equivalence between default on direct debt and default on guaranteed debt from a credit rating perspective means that the decision to honour these different types of financial obligations is likely to be equivalent to the sovereign as regards preserving its credit quality and associated standing and market access.

Spillover risks via sovereign-corporate-banking nexus

Rising loan guarantees intensify the sovereign-bank-corporate nexus

The increase in government guarantees to the non-financial corporate sector has intensified interdependencies between sovereign States, banks and firms. This has effectively created a “sovereign-bank-corporate” nexus[9]. Two potential negative feedback loops have been created: i) public finances are more exposed to developments in the corporate and financial sectors; and ii) banks and corporates have become more dependent on government support.

Figure 7. The sovereign-corporate-bank nexus
% of total assets (vertical axis); % of total loans (horizontal axis); government guarantees outstanding, % of GDP (bubble size)



*Based on latest take-up data
Source: Bruegel, Eurostat, AMECO, Scope Ratings GmbH

[9] See Schnabel (2021), The sovereign-bank-corporate nexus – virtuous or vicious?, Speech by Isabel Schnabel at the LSE conference on “Financial Cycles, Risk, Macroeconomic Causes and Consequences”.

Negative feedback loops exacerbate the effects of a withdrawal of public support

As such, a premature withdrawal of government support could lead to cliff effects, severely impacting the corporate sector and giving rise to financial instability. Such a scenario would likely trigger corporate defaults, a rapid rise in non-performing loans and tighter financing conditions, which could spill over to the banking sector. Here, the economic environment would worsen, government revenues would fall and public debt would rise, putting potential pressure on the sovereign's credit rating.

As such, the stronger the interdependencies within this sovereign-corporate-nexus (see **Figure 7**), and therefore the higher the potential contagion risks and potential macroeconomic costs, the stronger the incentives for the sovereign to honour its guarantees given that failure to do so is likely to lead to further deterioration in economic and fiscal outlooks. If a sovereign issuer faces severe financial distress, such a scenario could lead to a vicious cycle and push a sovereign to default on other financial obligations.

Sovereign incentives to honour guarantees during a debt restructuring

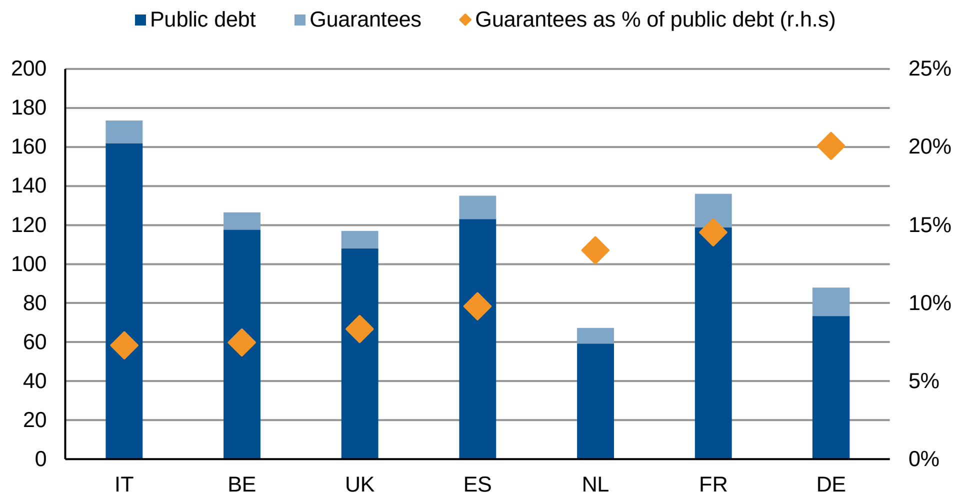
The materiality of guarantees could threaten long-term debt sustainability

Under an ultimate objective of placing sovereign debt on a sustainable path after a debt restructuring, attention also needs to be paid to the size of such liabilities in comparison to overall debt stocks. If contingent liabilities are material relative to outstanding debt stocks, leaving them out of the restructuring process could threaten the long-term sustainability of the sovereign debt profile (see **Figure 8**).

Restructuring government guarantees presents its own challenges

Another factor that determines if government guarantees are set to be included within the restructuring process is the assessment of the stand-alone credit quality of the guaranteed borrower and, specifically, the ability of the beneficiary to withstand a deterioration in the sovereign's credit risk. If the beneficiary calls on the sovereign guarantee to bring the liability into the restructuring process to treat it in line with other financial claims, the sovereign may be assuming a contingent liability that may never have materialised given that the borrower could have paid it at maturity without government support.

Figure 8. Materiality of government guarantees relative to public debt
% of GDP (l.h.s.); % (r.h.s.)



N.B. Uses the latest estimates for take-up of government guarantees.
Source: IMF, Bruegel, national draft budgets for 2021, Scope Ratings GmbH

If guarantees have already been called during a sovereign debt restructuring, they will typically be included in the debt restructuring and be subject to a potential haircut. If the share of outstanding guarantees is small compared to the total debt stock, however, the indebted borrower may decide to leave them out of the restructuring given the limited associated benefits in terms of nominal haircut debt volume and impact on debt sustainability[10]. On the other hand, if they are deemed to be material, creditors are unlikely to accept a restructuring agreement that excludes them.

Considering operational costs

Finally, one must consider the higher operational costs of restructuring contingent liabilities relative to writing down direct debt. Following the great financial crisis and the subsequent euro area sovereign debt crisis, collective action clauses (CACs) for sovereign bonds were introduced to streamline sovereign debt restructuring procedures, which are often highly complex given the need to co-ordinate the actions of a broad group of creditors[11].

Collective action clauses streamline direct debt restructuring…

CACs allow for a more effective restructuring if a qualified super-majority of outstanding debtholders agree to revised terms of repayment. In this case, remaining bondholders have to accept the restructuring terms. CACs relate to all bondholders of a single bond series[12] (i.e., per ISIN) and greatly reduce the operational burden of restructuring procedures compared with negotiating repayment terms on a creditor-by-creditor basis.

… while restructuring guarantees can entail high operational costs for limited added benefit.

By contrast, government guarantees are individual contractual agreements and do not benefit from similar legal provisions. Given that government guarantees have typically been issued to many firms, restructuring these guarantees would entail high operational costs including discussions with all the final debtors. This, combined with typically small potential gains in terms of haircuts on guaranteed debt relative to possible gains in restructuring the total sovereign debt stock, reduces incentives to pursue a restructuring of guarantees to allow for more operational resources to be devoted to treating the direct debt stock.

[10] In 2012, Greece underwent a restructuring of its public debt amounting to around EUR 200bn. The sovereign had guarantees on hundreds of outstanding debt instruments including loans and bonds. Only 36 sovereign guaranteed bonds issued by public corporations were ultimately included in the debt restructuring with the majority of guarantees being left out of the debt exchange. One of the criteria used by Greece to select these 36 bonds series was their classification by Eurostat (the statistical office of the European Union) as "central government debt" for Eurostat reporting purposes. See Zettelmeyer et al. (2013), The Greek Debt Restructuring: An Autopsy, PIIE Working Paper.

[11] Euro area member states have had to include CACs in all new long-term sovereign bond issuance since 2013.

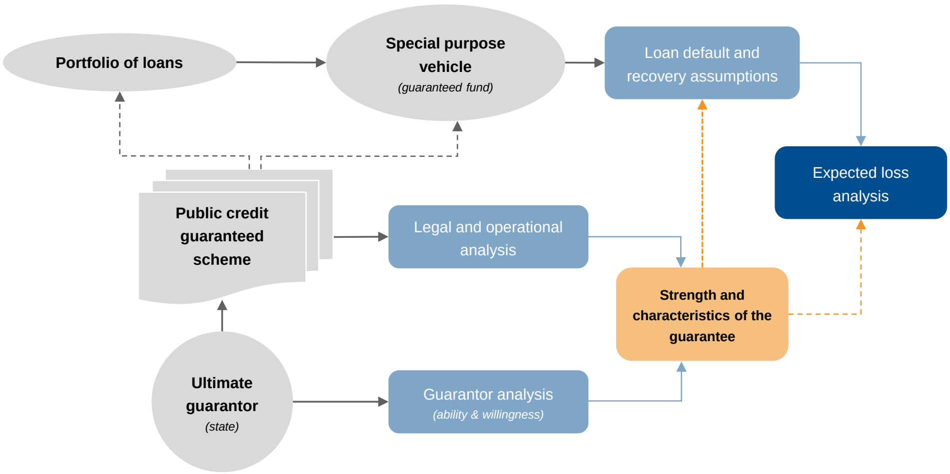
[12] ESM reform foresees single limb CACs from 2022 onwards.

Structured finance ratings implications

A multi-dimensional analytical framework

In the context of structured finance products, assessing the strength of State guarantees requires a thorough understanding of the sovereign's ability and incentives to honour its guarantees upon default, along with a review of the relevant legal and operational framework in effect (**Figure 9**). Additionally, various qualitative factors are analysed, such as the alignment of interests between the operator of the guarantee and the lender.

Figure 9. Overview of structured finance analytical framework



Impact on asset and liability assumptions

Taking the guarantee into consideration within the expected-loss analysis varies depending on whether it covers loan-by-loan losses, or applies directly covering the fund vehicle.

In the first case, credit given to the guaranteed amount may be reflected as recovery-upon-default assumptions, for which the timing heavily depends on analysis of the operational and legal process. Unsecured recoveries on top of the volume covered by the state are generally marginal. Fund guarantees offer credit enhancement in the form of a first-loss piece absorbing portfolio defaults up to a certain level.

No mechanistic link to the sovereign rating

Credit given to the guarantee scheme should not be limited to a mechanistic link to the sovereign rating. Instead, the incentives and ability of the ultimate guarantor to honour its obligations should be scrutinised. Scenarios where the guarantee does not operate as projected typically bear a low weight, and imply a certain level of macroeconomic stress, which is also correlated with the likelihood of local SMEs defaulting.

The SME default-rate implications of the guarantee scheme under normal conditions are not self-evident. There is not necessarily a large degree of correlation between the presence of the scheme and the likelihood of default for SMEs, provided appropriate risk-sharing arrangements are in place to control incentives and minimise moral hazard, particularly for lenders.

Public CGS are increasingly present in structured finance pools, either on a loan-by-loan basis, or more often in the form of dedicated guarantee funds. This trend could last as the appearance of Covid-19-related guarantee programmes could spur securitisation.

Scope has rated various SME ABS transactions in which CGS have played a role in the analysis, including some of the multiple initiatives led by the key multinational credit guarantee providers for European SMEs, namely the European Investment Fund (EIF), the EU's SME financing agency, and the EIB.

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