How does a guarantee scheme work?

Bruno Robino, EIB, Head of fi-compass

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Objective: provide better access to finance to targeted Final Recipients (typically addressing a market failure identified in ex ante assessment)

- Providing better access to finance to targeted SMEs (full advantage passed on to SMEs), addressing concrete and well identified market gaps.

- Leveraging the ESIFs to support financing for SMEs.

The Capped Portfolio Guarantee provides credit risk coverage to intermediaries on a loan by loan basis, up to a Guarantee Rate, for the creation of a portfolio of new loans to SMEs up to a Guarantee Cap Rate.
First Loss Portfolio Guarantee – at a glance

**Portfolio of New Loans**

- **Total Loans’ amount**: Bank risk
- **Guarantee Amount**: Guarantor risk
- **Guarantee Cap Rate (X%)**: Guarantee Rate (Y%)

**Objective**: access to finance, with improved lending conditions for Final Recipients (reduced interest rates and/or collateral requirements)

- Cap Amount available to cover losses in the Final Recipients loan portfolio;
- For each loan defaulting, [Y]% (guarantee rate) of the covered loss is paid to the bank;
- This holds until [X]% (cap rate) of the portfolio is covered.
Capped Portfolio Guarantee

Multiplier*: 
\[
\frac{1}{\text{Guarantee Rate}} \times \frac{1}{\text{Cap Rate}}
\]

Minimum: 
\[
\frac{1}{0.8} \times \frac{1}{0.25} = 1.25 \times 4 = 5
\]

Guarantee Rate: up to 80%

Cap Rate: determined in ex ante risk assessment (≠ ex ante!) up to 25%

ESIF contribution

*determined in ex ante risk assessment
Capped Portfolio Guarantee

Further key features:

• Lending methodology to ensure that the full financial advantage is passed on to SMEs – reduction of interest and/or of collateral of each and every loan;

• Portfolio must include new loans (no refinancing!), up to EUR 1.5m each (granularity), for a term of 1 to 10 years (Lending policy – CIR 964/2014);

• Loans for:
  • investments in tangible/intangible assets, including for take over of other enterprises if transfer is between independent investors. But no pure financial activities, real estate development or consumer finance can be supported;
  • working capital related to development or expansion ancillary to investments.

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Further key features (ctd):

- Eligibility criteria to be aimed at (i) reaching a **large number of recipients**, and (ii) achieving sufficient **portfolio diversification** ➔ no overspecialisation!

- No revolving credit lines, no equity, no subordinated or mezzanine debt;

- No fees payable by financial intermediary.

- Alignment of interest:
  - Performance fees;
  - FI to always keep at least 20% of risk in its own books.
Capped Portfolio Guarantee

The set-up of the instrument is State aid cleared:

- At FoF and FI level, State aid free as long as:
  - Remuneration in line with Regulations and market – FInt. selected in open call;
  - FInt. covers the remaining 20% of risk with own resources;
  - Financial advantage fully passed on to SMEs.

- At SME level, under de minimis as long as:
  - GGE is below EUR 200k (including cumulations);
  - Other general rules regarding de minimis.
Pricing policies flow

Funding Agreement

Portfolio guarantee contract

Loan contract

MA/FM

FM/Bank

Bank/SME

Transparent methodology for pricing and collateral requirement

Obligation to respect the methodology for all the loan included in the portfolio

Collateral/Interest rate reduction

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Guarantee - Transfer of benefit to SMEs

**FLPG**

- Subsidised guarantee
- Delegation principle: eligibility & risk assessment by banks
- Possible capital relief – reduced regulatory capital charge

- Significantly lower collateral requirement
- Reduction of risk related margin (decrease in the interest rate)
- Decreases in fees (based on call application)

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Main advantages of Guarantee instruments

For MA:
• Leverage effect (> than for a loan),
• Alignment of interest (FInt. “skin in the game”),
• Finance viable investment.

For Banks:
• FInt. risk coverage means reduce the overall exposure of banks (see e.g. following slide),
• Improves bank reputation (more willing to extend loans to SMEs),
• Sometimes allow banks to get capital relief.

For SMEs:
• Easier access to finance, since FInt. risk coverage,
• Collateral reduction,
• Interest rate reduction (cost of risk should be reduced) (< than for a loan).
Capped vs Uncapped Guarantee

Guarantee rate on a loan by loan basis up to the cap rate

Financial Intermediary Risk

Risk covered by ESIF Contribution

Guarantee cap

Sr. tranche

Mezzanine tranche

Jr. tranche

Investor A

Investor B

ESIF Contribution
SME Initiative
General overview

• Legal basis of the SME Initiative: Article 39 CPR
• Key objectives
  • Leverage EU budget by mobilising private resources
  • Incentivise financial intermediaries to extend new debt instruments (loans, leases, guarantees) to SMEs
  • Enhance access to SME finance through a reduction of the overall interest rate charged (transfer of financial benefit)
  • Provide loan loss protection and capital relief on the portfolio to be originated

• Two risk-sharing instruments endorsed by the European Council:
  • **Option 1: Uncapped portfolio guarantee facility** for portfolios of new SME loans/leases up to 80% guarantee rate
    • *Signed mandates in Spain, Malta, Bulgaria, Finland and Romania*
  • **Option 2: Securitisation** instrument for portfolios of both new and existing SME loans, where the originators undertake to provide new financing
    • *Signed in Italy*
Option n°1
Uncapped Guarantee instrument

New Portfolio of debt finance

Option n°1:
Provides un capped portfolio guarantees and envisaged partial capital relief to banks building up new portfolios of loans

Description:
• Originators (gradually) builds-up a portfolio of new SME loans;
• EIF issues uncapped portfolio guarantees (up to 80%) and shares the risk with banks;
• ERDF/EAFRD are used to cover the first-loss piece;
• EU funds from COSME/HORIZON 2020 and the EIF join to absorb, along with ERDF/EAFRD, the second-loss piece;
• EIB and possibly NPB guarantee the senior tranche.

In return the originators will have to transfer benefits of the instrument to the SMEs in the form of acceptance of higher risk clients, reduction of collateral requirements and/or reduced pricing.

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Option n°2:

Securitisation instrument can be backed by portfolio of existing SME loans

Description:
- A portfolio of existing SME loans is identified
- 50% of the first-loss piece is retained by the originator and 50% is covered by ERDF/EAFRD
- The risk of the second-loss piece is covered by ERDF/EAFRD, EU funds from COSME/HORIZON 2020 and the EIF. Originator possibly retains 5% of the risk
- EIB and third-party investors purchase or guarantee the senior tranche up to agreed maximum amounts

In return the originators explicitly undertake to provide new financing (amounting to multiple of the EU Funds contribution) to SMEs in the relevant regions in line with the eligibility criteria the EU funds contributed in the structure
SME Initiative
Option 1: Transfer of Benefit to SMEs

Credit Spread & Cost of Capital = 3.55%

Profit Margin = 1.00%

Admin cost = 1.50%

Funding Cost = 1.50%

Before the Guarantee
Loan Interest = 7.55%

Cost of the Guarantee, i.e. 60bps on the guaranteed portion

Credit spread reduction thanks to the Guarantee

Credit Spread & Cost of Capital

Profit Margin

Admin cost

Funding Cost

[0.60%]

After the Guarantee
Loan Interest = 6.08%

All numbers are indicative and for illustrative purpose

#ficompas
# SME Initiative

## Main Benefits

<table>
<thead>
<tr>
<th>For SMEs</th>
<th>Easier/better access to bank financing</th>
<th>Significant Transfer of F. Advantage: ESIF have a zero cost on the equity tranche</th>
<th>More opportunities for innovative SMEs and new technology-based firms</th>
<th>Helps to mitigate financial market fragmentation in the EU in terms of credit cost</th>
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<td>For Member States / Region</td>
<td>No national co-financing required</td>
<td>Ex ante assessment already done by the EC</td>
<td>Aligned to MS priority objectives</td>
<td>More efficient use of ESIF Transition from a subsidy culture to revolving financial instruments</td>
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<td>State Aid is cleared, no additional negotiation of state aid schemes required</td>
<td>Clear governance structure</td>
<td>SME credit growth may drive economic growth</td>
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<td>For Financial Intermediaries</td>
<td>Credit protection</td>
<td>Capital relief</td>
<td>Access to new clients/segments</td>
<td>High visibility for SME support</td>
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SME Initiative: Deployment (1)

SME Initiative Finland:

- Signature of the relevant agreements between the Republic of Finland, the European Commission, EIF and EIB: **14/09/2016**
- Expected **EUR 400 million** of new SME financing to be provided
- Call for expression of interest published: **15/09/2016 with deadline for application 31/03/2017**
- 6 financial intermediaries applied for a total portfolio of EUR 690m
- 3 financial intermediaries are now providing loans, others to join in the near future
- Very good market response, “oversubscribed” by EUR 290m
- More than **EUR 80 million** already committed to more than **130 SMEs** according preliminary data.

SME Initiative Romania:

- Signature of the mandate agreements between the Republic of Bulgaria, the European Commission, EIF and EIB: **20/10/2016**
- Expected **EUR 540 million** of new SME financing to be provided
- Call for expression of interest published: **21/10/2016 with deadline for application 31/03/2017**
- 5 transactions signed up for SMEi Romania, namely Banca Comerciala Romana, Banca Transilvania, Bancpost SA, Procredit Bank Romania, Raiffeisen Bank Romania, ProCredit Romania, Libra Bank, ING for the amount of EUR 540m.
- Number of SMEs loans signed: **25** for the amount of **EUR 12m** as of **Q2 2017**
SME Initiative: Deployment (2)

SME Initiative Bulgaria:

• Signature of the mandate agreements between the Government of Bulgaria, the European Commission, EIF and EIB: **02/03/2016**
• Expected **EUR 600 million** of new SME loans to be provided
• Call for expression of Interest published: **17/05/2016** with deadline for application **30/11/2017**
• 10 transactions signed with Financial Intermediaries for the amount of EUR 608m
• Number of SMEs loans signed: **1,471** for the amount of **EUR 150m** as of Q2 2017