What was the role of credit guarantees for leasing and credit finance during the crisis?

By Amina Chakchouk, COO Leasing; Riadh Ben Salem, iMX Application and Business Expert; and Riyadh Smedhi, iMX Application and Business Expert, CODIX

IN LIGHT OF THE COVID-19 PANDEMIC, a crisis which has shaken the world, the leasing and credit institutions were left with many questions, such as how to manage liquidity in these difficult times. In response to the crisis, a number of support measures have been implemented, including rescheduling for the lockdown period with smoothing of the capitalised interest at the end of the contract, moratoriums on loan repayments, and deferments of tax payments.

As the world is slowly, but surely taking its first steps toward re-opening and recovering from the crisis, the outlook remains uncertain. Credit guarantee programs have played a major role throughout the pandemic and are expected to increasingly support the recovery of Leasing and Credit Finance Institutions.

In normal circumstances, SMEs generally find it difficult to obtain the necessary financing, even when they present viable projects. This difficulty is due to the reluctance of the financial institutions to extend uncollateralised credits, even at high interest rates, because of the high cost to obtain adequate information on the true risk and profitability of the projects behind loan applications by SMEs.

This phenomenon is often called the SMEs financing gap, and definitely SMEs have been more impacted by this credit rationing during the pandemic than larger companies, which follow certain reporting standards.

The use of collaterals could alleviate credit rationing as it provides additional sources of repayment in a case of a default. It also increases the borrower's default costs, thus giving SMEs a greater incentive to repay their loan. However, collaterals may not always be available due to a number of reasons. Firstly, the amount or asset type that will serve as a collateral may not be available to SME. Secondly, the asset value may be higher than the amount of the loan which may lead to an undervaluation. Finally, the use of collaterals involves costly legal and administrative procedures.

This has hampered access to loans for SMEs during the pandemic; at the same time leasing and credit institutions are reluctant to use higher interest rates to compensate higher risk, as they risk repelling lower-risk borrowers while encouraging high-risk ones. Add to this a crisis and lockdowns all around the world and you have a real dilemma.

This is where Credit Guarantee Schemes (CGS) come into play which could alleviate the financing deficit by substituting the use of a collateral with a credit protection provided by an external guarantor. The CGS are used in leasing and loans to alleviate the constraints faced by SMEs in accessing finance.

How does the Credit Guarantee Scheme work? Three different approaches can be used by the CGS:

Individual approach. Within this approach, the guarantor approves on a single basis each financing request. The customer/lessee/borrower applies, presents its project to the guarantor who studies the project. Based on the provided information and risk analysis, a letter of guarantee is issued to the customer who then applies for a loan in a partner bank. The guarantor is not involved in the negotiation process between the lender/lessor and the client/lessee.

Portfolio approach. Under this approach, the guarantor negotiates with the lenders the criteria for approval of the loan, as well as the total amount which will be guaranteed. Under this scheme, the lender discretionarily approves the loans to borrowers, meeting the pre-agreed criteria and informing the guarantor of their decision.

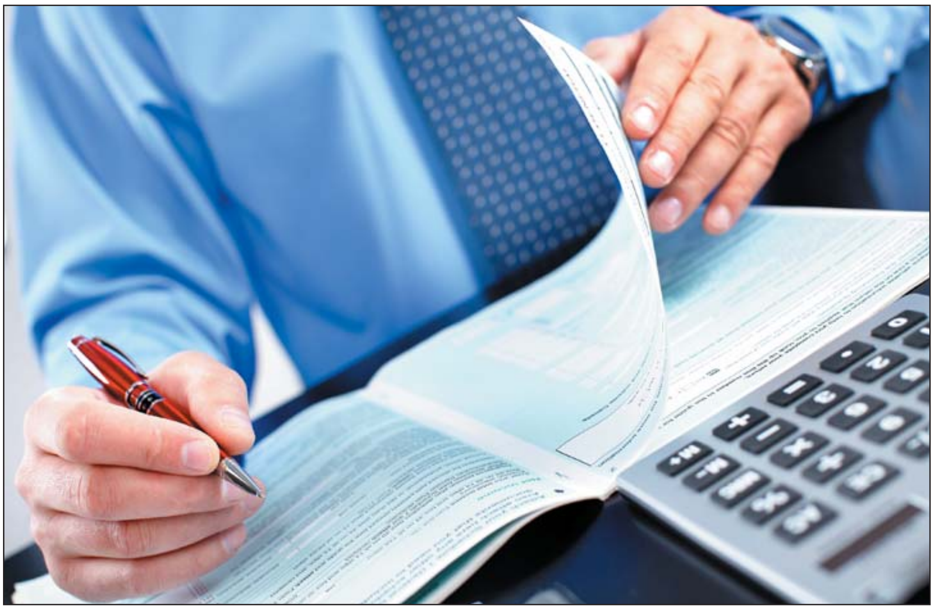
Hybrid approach. Here the agreement is based on hybrid mode – a portfolio approach is applied to certain types of loans and an individual approach for other types of loans/leases/type of financing.

Each CGS agreement sets out the eligibility criteria to be met. In general, these criteria are included in the agreement between lenders and guarantors in a case of portfolio approach, and must be reviewed by the lender/lesser in such a case, or are checked by the guarantors directly in a case of individual approach.

Examples of eligibility criteria include:

- Size of the company: number of employees
- Term of the loan: long-term, medium-term or short-term
- Loan size/amount
- Age of the company or the borrower
- Type/sector of activity
- Type of asset subject to financing

Coverage provided by the CGS. Regarding the coverage provided by the CGS, several key elements have to be considered:



Credit Guarantee Schemes are used in leasing to alleviate the constraints faced by SMEs in accessing finance.

Coverage ratio. Each guarantor can specify in each agreement with lenders the coverage ratio that can be applied or the coverage ratio formula depending on certain conditions related to the financial request. The highest coverage ratio can be very attractive to lenders, but in general it should be below 100% in order to maintain the lender's liability for credit risk and to engage them to carry out appropriate risk monitoring.

The coverage ratio can be a fixed or scalable coverage rate depending on the situation of the borrower and their activity or on the economic business model, the government policy and incentive for the country development. Example of better coverage ratios, which depend on borrower's activity and situation, include sustainable activity, younger start-ups, women, etc.

Elements eligible to CGS. Does the guarantee cover the principal unpaid loan or on principal and unpaid interest or on principal, interest and fees incremented by the lessor/lender? Each formula has its advantages and disadvantages.

Coverage duration. In principle, the loan is covered until the maturity term, but there may also be restrictions. For example, CGS may limit the duration to five years or if the parties decide to terminate the guarantee earlier than the credit maturity. The amount of the premium is then reduced, but the guarantor is committed to cover only the first years of the loan, which are often the riskiest.

Coverage limit and stop loss. In some CGS policies, the guarantor covers up to a ceiling the absolute value defined in the contract for the total amount of claims.

Guarantee fees, commissions, withdrawing guarantees. Each CGS has its own policy and, depending on coverage, may charge fees or commissions which can be applied to the lender who can re-invoice them to the customer, or fees invoiced by the GCS to the borrower in case of an individual approach.

Banks will charge a one-off fee for issuing the guarantee which can be a flat amount or a percentage of the guaranteed amount. Further regular fees are payable by the Applicant while the Guarantee is active, so that the bank can maintain its obligation to pay and reissue the guarantee if it expires in time. These charges will vary considerably depending on a range of factors, including the value of the fluctuations in the guarantee's exchange rate, the risk incurred by the bank, the Applicant's relationship with their bank, and/or the duration of the guarantee.

Some types of CGS, such as a funding guarantee or the so-called withheld or guarantee account, are a sum of money constituted at the beginning of the lease/factoring contract to guarantee the lessor/factor a reimbursement from the company which has taken out a factoring contract or from the vendor/partner in case of vendor-based leasing of all the sums due upon application of the factoring contract (unceded assets, direct payments, etc.) or leasing application.

In a way, this is a reserve of money, which is constituted by the lessor/factor either on the assignment of invoices given by the factor or on the payment of supplier's invoice in the lease. This reserve of money will be used in a case of non-payment in order to immediately cover the debt.

Activation of the guarantee policies. In general, the CGS requires the lender to perform all necessary late collection activities and procedures to ensure that the lender acts responsibly and to avoid opportunistic behaviour of the lessor/lender. The guarantee can only be activated after a number of conditions have been met, such as the examples listed below:

- the borrower's default is recognised;
- legal actions are initiated by the lender against the borrower in case of default;
- legal procedures against the borrower have been completed.

In case multiple CGS are involved in the financing request, a priority order may be defined to determine the activation sequence of each. Of course, proof of response from a higher priority CGS must be provided.

What are the main Credit Guarantee Schemes used in leasing and lending? There are several guarantee schemes which can be applied:

- Public credit guarantee schemes – guarantee provided by the government with a policy object to extend and support access to finance for companies in difficulty.
- Corporate credit guarantee schemes – guarantee provided by the private sector and managed by business executives. These schemes can give advantages to borrowers and lenders.
- International Guarantee schemes – guarantee managed and

given by organisations to support the development and assistance of countries in difficulty.

- Mutual Guarantee schemes – guarantee provided by private organisations which have objectives independent from the governments, but usually benefit from government support,
- Funding Guarantees managed by financial institutions – largely used in leasing or factoring by the lessor for self-management and risk sharing with suppliers and vendors. These Schemes give greater advantages to high-risk clients (e.g., start-ups) and significantly reduce the risk of financing. Funding Guarantee schemes are completely independent from governments.
- Guarantees by signature – used for different purposes to cover different credits. This guarantee is the commitment made by a bank to make funds available to its client or to intervene financially in the event of default by the client. Also, this guarantee allows a company to determine its financing, to exercise its activity, to defer its payments, to avoid payments or to accelerate the inflow of funds. Different types of Guarantees by signature are used, such as Funding commitments, Professional guarantees, Deposits to defer payments.

Accounting treatment of the guarantee. The guarantees granted do not appear in the balance sheet, in the traditional accounts. They certainly represent the seat of potential future risks. Still, it is not about a debt until it is called or "mobilised" by credit institutions. These are commitments that appear in "off-balance sheet".

However, the international accounting standard (IAS) 39, published in 2005 by the International Accounting Standards Board (IASB), requires the issuer of guarantees to present financial guarantee contracts at their "fair value". Professional literature considers a value to be possible gross or net worth.

In "gross" accounting, the present value of the guarantee premiums to be received appears as an asset on the balance sheet and the guarantee commitment as a liability. The "net" method allows, as in traditional accounting, net zero values if the terms are equivalent and as long as there is no evidence to the contrary (IAS 39, Appendix A, AG 4 (a) 43, 44). After the treatment at fair value of loan instruments – including guarantees – had come under criticism (45), the IASB adopted a new standard – IFRS 9 – which should replace IAS 39 from 2015 (46).

In practice, the accounting treatment of guarantees issued is not uniform. For example, in the West African Economic and Monetary Union (UMEOA) guarantees are counted in Chapter 9 of the Accounting Standards and not in the balance sheet (but off-balance sheet).

The guarantees that will probably be called in payment given the loan situation must be provided.

Provisions, both in traditional standards and in IAS (47) standards. (Source giz 2021)

What are the pros and cons of using Credit Guarantee Schemes in leasing? The use of CGS in leasing is as beneficial for leasing companies as it is for SMEs. It enables the former to finance projects that they consider high risk, and it allows the latter to obtain the necessary financing under better conditions.

Credit Guarantee Schemes enable a leasing company to finance projects that they consider high risk.

Businesses could get market opportunities that were previously unavailable; thanks to CGS they would also see their credibility increase as it is backed by the CGS.

However, SMEs must undergo a rigorous assessment by the entities providing the guarantees, in order to establish a clear financial analysis of the applicant before issuing the guarantee. Also, a collateral in the form of a movable could still be required if the guarantee is not enough.

The opponents of CGS claim that:

- Financial institutions have the best lending technologies and are better placed to extend and approve credit to SMEs.
- CGS lead to exacerbation of moral hazard, especially the public CGS, justifying that the government intervention in credit markets should be avoided.
- CGS lead to potentially high fiscal costs that would outweigh the benefits of providing credit to individuals, rationed groups.

On the other hand, CGS supporters argue that it creates "additionality"; meaning they give access to credit to groups that would not otherwise have had it without their existence. In addition, providing finance to credit rationed groups through the CGS may result in increased activity that would generate spillovers in which the social benefits outweigh the potential costs of the CGS (Honohan, 2010).

What are the benefits of integrating the Leasing Management System (LMS) with the Credit Guarantee System (CGS)? In order to eliminate the disadvantages of CGS and make it more profitable and less risky for the different parties, the necessary technologies and tools must be found to offer or allow integration with the credit and leasing system.

- Management of different kind of guarantees and CGS in the credit and leasing system.
- Integration during the process of acceptance with the provision of a special assessment for CGS to avoid the high risk of loss or non-payment.
- Integration of financial scales and pricing:
  i. limit it with the special application condition;
  ii. integrate the costs as subsidies or commissions that will be shared with different parties;
  iii. integrate a remuneration rate on the deposit or withdrawing done or automatically update it in accordance with the situation of the credit.
- Good governance tool and integrated risk management to react immediately and make an equilibration that is the most efficient for the third parties.
- Automatic integration with collection processes in order to immediately cover the unpaid from the most available guarantees and at the same time to continue the collections from customers.

Whether or not a lessor will seek a lease collateral depends on many factors, such as the lessee credit history, the credit rating, or the company policy and the terms of lease. Here, it is possible for lessors to automate their acceptance processes, using software such as iMX to automatically request guarantees and collateral, whenever the contract type or the credit history of the lessee requires it.

The software automatically identifies the amount and the type of lease collateral to request, depending on the value of the leased equipment and the type of asset. For example, the lessee can present their list of account receivables, asset inventories or real estate as a guarantee and iMX will determine whether they are sufficient to cover the default risk, depending on the specific terms of the leasing agreement and risk tolerance.

Of course, the lessor might want to do an evaluation of the provided collateral prior to accepting the leasing agreement. This process could be automated by using dedicated evaluation services which will input their assessment directly into iMX through dedicated portals or web services.

It is also possible to parametrise different motives for the action and use of guarantees, such as late collection processes.

To conclude, although they have not completely eliminated the need for collateral, credit guarantees have proved essential in supporting SMEs financing, especially during the Covid crisis. Add to the equation a leasing management system and SMEs will profit from a coherent and effective credit guarantee scheme. Even in less developed economies banks are showing willingness to use CGS on a larger scale.

CGS have played and will continue to play a significant role in maintaining and developing credit guarantee frameworks for SMEs.

Amina Chakchouk

Riadh Ben Salem

Riyadh Smedhi

Authors:
Amina Chakchouk, COO Leasing
Riadh Ben Salem, iMX Application and Business Expert
Riyadh Smedhi, iMX Application and Business Expert

CODIX
200 Rue du Vallon, Sophia-Antipolis, 06560 Valbonne, France
Tel: +33 4 89 87 77 77
Email: info@codix.eu; **Website:** https://www.codix.eu