POLICY BRIEF * COVID19 ECONOMY GROUP

Bank guarantee scheme to bridge finance the economy

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Introduction

Many businesses have had cash flows substantially diminished because of the lockdown and wider economic disruption from Covid-19. These businesses, that would be viable were it not for Covid-19, require urgent funding to bridge them to the other side of the crisis. Failure to support them will lead to widespread business liquidations and staff layoffs and trigger wider distress in their supply chains. This will cause a permanent loss in output that will make the post Covid-19 recovery slower and reduce potential long-term GDP.

As part of their economic responses to the crisis, many countries have turned to their banking sectors as part of the solution. South Africa benefits from a well-developed financial system and efficient banking sector. Credit penetration accords with that of developed markets and banks already operate large commercial loan books. They are well positioned to manage the administration and vetting of a large scheme to extend bridging finance.

This paper advocates for the introduction of a guarantee scheme to effectively enable to banking sector to undertake largescale lending to bridge finance companies through the crisis. We propose that the scheme initially target lending volumes of R200bn, using a combination of funding from the SA Reserve Bank and a guarantee fund that accesses grants and concessionary funding. This approach is the least fiscally harmful mechanism for a guarantee scheme that we can determine. Strict conditions must apply to banks in using the mechanism to prevent any abuse or unintended consequences.

As of 3 April 2020, 51 countries had provided some form of bank guarantee scheme as part of their economic responses to the crisis[3]. These include both developed and developing countries, including in Africa (Algeria, Tunisia). The size of support ranges up to 15% of GPD in the case of the United Kingdom but several are at 1.8% of GDP. Some countries that have not introduced guarantee schemes are providing funding to businesses directly or via state-owned development finance institutions. Usually, schemes were announced and rapidly deployed with banks proactively offering facilities within days of announcements.

Banks face a crisis too

The health crisis presented by the pandemic is also an economic and financial crisis. Analysis by Intellidex[4] finds that banks are likely to experience a significant impact on their balance sheets and income statements as a result. In particular:

[1] This memo was prepared by Stuart Theobald, drawing on input and comment from the Covid19 Economists Group, convened by Miriam Altman and including Andrew Donaldson, David Francis, Imraan Valodia, Alex van den Heever, Mzukisi Qobo, Tania Ajam and Wandile Sihlobo. It draws on a proposal developed by the author with colleagues at Intellidex with substantial contributions from Peter Attard Montalto. The paper also benefited from feedback from other researchers and the engagement of the Presidency, National Treasury and several banking sector respondents. The result is the responsibility of Stuart Theobald alone.

[2] A version of this paper was circulated as a discussion document on 5 April under Intellidex masthead. Some editing updates were made to this paper on 19 April 2020.

[3] According to the author's analysis of the International Monetary Fund's database of policy responses to Covid-19 available at https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19

[4] Published as a discussion paper on 26 March 2020 and available at https://www.intellidex.co.za/wp-content/uploads/2020/03/Intellidex-how-banks-deal-with-Covid.pdf

- The crisis will substantially reduce the credit performance of bank clients, requiring banks to raise additional provisions for bad debt in terms of accounting standards (IFRS 9) that require banks to set aside money as soon as they become aware of a worsening outlook for credit performance.
- The crisis will substantially reduce banks' new business flows as transactional volumes decline and fewer clients apply for credit.

Our baseline view is that banks will collectively see a R120bn decline in revenue compared with 2019, which will leave them R35bn in the red in 2020. But the risks are to the downside: a longer lockdown and/or slower recovery could substantially increase this amount. Our analysis, however, shows that in the baseline scenario banks still remain marginally within Tier 1 capital buffers, but in a negative scenario banks will fall into violation of Basel 3 capital requirements, though they may still remain solvent.

This is a stressed environment for banks which will drive them to behave conservatively, reducing risk tolerance and therefore their willingness to extend credit. Yet at the same time, banks are expected to play an important role in confronting the crisis by granting existing clients forbearance by extending the terms of their loans and either forgoing or capitalising interest. Banks are also facing pressure on liquidity in that many clients are switching term and fixed deposits into call deposits as they prepare to access their reserves to trade through the crisis. Turmoil in the bond market has also seen the value of bonds decline, reducing banks' stock of near-cash assets. Banks are also being conservative in trading with each other, holding on to liquidity as a precaution. So liquidity is under pressure as the terms of liabilities shorten while forbearance means the terms of assets lengthen.

Reserve Bank action so far

The Reserve Bank has acted quickly to accommodate the pressures facing banks. It has done so through several measures. In respect of capital adequacy, it has[5]:

- Reduced banks' Pillar 2A of Tier 1 capital requirement of 1% to 0%. This buffer on top of the basic minimum Tier 1 capital requirement is held for systemic risk.
- Stipulated that banks' capital conservation buffer of 2.5% of assets can also be used should the capital freed by the Pillar 2A relaxation be exhausted.

These two measures assist banks in being able to absorb the losses they will face and the consequent drop in their capital levels. While some have seen this as stimulatory in allowing banks to increase lending by reducing the capital that must be held for loans, we see it as merely accommodative of the pressures banks face on existing business. A further move has been to clarify the application of IFRS 9 in the case of forborne loans, allowing banks, in some circumstances, not to increase provisions for such loans.

In respect of liquidity, the Reserve Bank has taken several measures. Regarding liquidity ratios, it has reduced the Liquidity Coverage Ratio (LCR) from 100% to 80%. This move allows banks to hold less near-cash assets to cover a liquidity stress scenario in a month. That should in theory allow banks to increase lending, but again, in our view, it merely accommodates the liquidity stress banks are facing.

The Reserve Bank has also announced changes to the liquidity it provides the market including:

- Increasing the number of intra-day overnight repo auctions to two per day with amounts set for each auction depending on liquidity conditions.
- Adjusting the standing facilities borrowing rate, at which the SARB absorbs liquidity from the market, to the repo rate less 200 bps (from repo less 100 bps). This reduction in the rate discourages banks from depositing liquidity with the SARB but rather direct liquidity into the money market.

[5] The Bank's announcement is available here: https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/9843/D2%20of%202020%20-%20Matters%20related%20to%20temporary%20capital%20relief%20in%20light%20of%20COVID%2019.pdf

- Adjust the standing facilities lending rate at which banks borrow from the SARB to the repo rate (from repo plus 100 bps). This makes it cheaper for banks to acquire liquidity from the SARB.

All these measures improve bank access to liquidity. The Reserve Bank has also announced a programme of buying bonds in the secondary market to maintain market order, which assists banks that hold bonds, the value of which had become erratic.

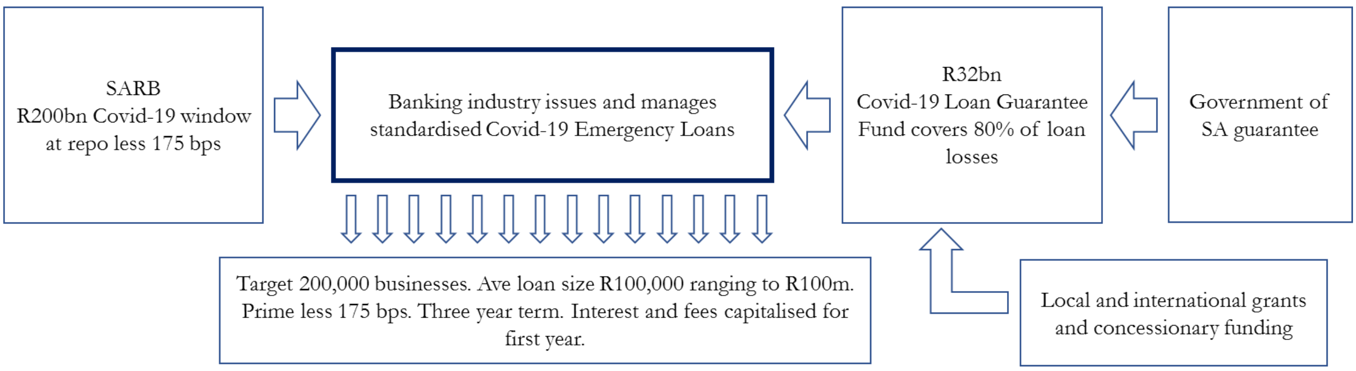
Our proposal

The problem is that the measures so far serve to accommodate the stress banks face but do not provide for stimulatory measures such as a substantial increase in lending to the economy to bridge it through the crisis.

Our proposal aims to address the following issues:

- Provide funding to the banking system to finance a concession loan scheme with no cashflow impact on recipients for 12 months.
- Move enough risk off bank balance sheets and provide enough margin to ensure banks face a breakeven financial position from the scheme, while benefiting from improving the credit resilience of their SME and commercial books.
- Minimise the cashflow impact on government as well as contingent liabilities.
- Ensure the scheme is large enough to make a substantial impact on the survival outlook for hundreds of thousands of businesses.
- Ensure the scheme can be rapidly implemented to prevent businesses from closing in the short term.
- Manage free rider risks in the banking industry as well as the risk of shifting existing risk from bank balance sheets to the government.

Figure 1: Overview of proposed guarantee scheme



A Covid emergency loan scheme should be provided with R200bn of funding (1.8% of GDP) with standardised terms and conditions, to be offered by all registered banks with commercial clients. Loans should be issued at 1.75% below prime (i.e. 7% currently) with interest and fees capitalised for the first year on a three-year term.

We propose that the Reserve Bank provide R200bn of funding to the banking system through a special Covid funding window at 175 basis points below repo. There should be strict conditionality attached to the funding to ensure compliance with the Covid loan scheme rules. The Prudential Authority should play an oversight role of banks that draw on the window, with powers to issue fines for non-compliance.

A Covid-19 Loan Guarantee Fund (CLGF) should be established with R32bn of funding that would serve as a buffer against for a guarantee underpin from government. 80% of the loans should be guaranteed (i.e.

R160bn of the R200bn), with the balance remaining as risk on banks' balance sheet to incentivise appropriate risk management. The Covid-19 Loan Guarantee Fund should be funded from a variety of sources including public resources and international assistance. We have elsewhere proposed a Covid-19 Impact Bond, the proceeds from which could fund the guarantee fund.

The funding window

SARB has introduced special measures to support liquidity in the banking system that we outlined above.

We propose that the SARB provide a new window alongside its accommodative activities at which banks can obtain liquidity specifically for the Covid-19 lending scheme. This facility should be provided at repo rate less 200 bps (subject to a floor of 0%). Terms should be for three years and the window should be open only for one month, extendable on a month-by-month basis.

Access to funding at the Covid-19 window should be subject to strict conditions imposed on the banks concerning the Covid-19 loan scheme, which we detail below.

The SARB can widen the eligible collateral it currently accepts for funding at the discount window. This would enable banks more easily to access the Covid funding and ease up their overall liquidity profile (in line with separate measures the SARB has taken to support bank liquidity including reducing the Liquidity Coverage Ratio). Currently eligible collateral includes government bonds, treasury bills, SARB debentures, Land Bank bills and Separate Trading of Registered Interest and Principal of Securities (STRIPS). The availability of such collateral constrains the banks' ability to access liquidity and may be insufficient for the funding needs of the Covid-19 loan scheme. Therefore, the SARB could widen acceptable collateral to include SOE bonds, for example, particularly those guaranteed by government. A further widening would be to accept corporate bonds issued by AAA domestic scale-rated banks. Because the scheme is effectively guaranteed via the CLGF and the government guarantee, the actual risk faced by the SARB is minimal (ring-fencing of the loans on the balance sheets of banks may be appropriate so the SARB has full recourse to the loans).

The window would expand the SARB's balance sheet, but specifically by driving funding into the real economy in a time of crisis on a temporary basis. Such decisive action would, we believe, be seen as credible by the market.

The guarantee

The Covid-19 Loan Guarantee Fund would be the main external funding requirement for the scheme and lessen the burden placed on the fiscus by the scheme.

There are two alternatives to guaranteeing the scheme: a direct guarantee by National Treasury or an advance-funded portfolio ready to meet cash calls from banks in terms of the scheme. We believe the advance-funded option is preferable because the fund can access sources of new funding that may not be available to the government directly. However, a Treasury guarantee would still stand behind that to ensure the guarantee scheme is risk-free for banks and the SARB.

Figure 2: Overview of Guarantee Fund

The R32bn funding requirement is premised on the loan scheme impairing 20% of all loans and the fund then absorbing 80% of written off loans.

In particular, sources of funding for the CLGF might include:

- Domestic philanthropic sources including the Solidarity Fund and banks' own foundations.
- International grants from multilaterals and other global diplomacy (such as G20) providing global crisis funding.
- Concessionary funding from global sources designed to fund the Covid-19 crisis response. These would be repayable, but concessionary terms can lower the overall cost of the guarantee to government.
- Domestic concessionary financing raised, including from a Covid-19 Impact Bond which we have proposed elsewhere.
- Concessionary finance from domestic development finance institutions and from quasi-government savings like the GEPF which could be offered instruments in return for investments in the fund.

This approach would rely on grants as far as possible, then concessionary finance, and so would reduce the overall cost to the fiscus compared with a straightforward guarantee.

The R32bn target need not be achieved at the outset but can be synergised with funding through the SARB window. E.g, if R2bn is raised at first, R10bn of funding can be made available at the window, increasing as the guarantee fund accumulates funds.

Importantly, once the mechanism is established, the scheme volumes can be grown in a straightforward way if needed.

We have proposed that the fund should hold assets equivalent to 20% of the total loaned through the scheme. On a R200bn loan objective, with R160bn guaranteed, it follows that holdings would need to be R32bn.

The 20% is an early projection of likely impairments on the loan book of the scheme. This is considerably higher than normal commercial loan book impairments as we anticipate those accessing the scheme will be facing a heightened level of distress by definition. Performance will have to be monitored and amounts increased or decreased in response consistent with IFRS 9 principles.

In the event of a cash call by a bank to the fund, the fund should assess each loan to ensure it meets the terms of the schemes discussed below. Loans that fail to meet the terms will not be paid out, creating a strong incentive for banks to ensure compliance. Loans would be deemed in default when they are three months past due.

The balance of 20% of loans would remain a balance sheet risk for banks. This is to ensure that banks have an incentive to work to maintain the credit performance of the loans and to apply appropriate credit assessment at the time of issuance. In the event of the CLGF paying out, the CLGF will take ownership of 100% of the loan, which it can then cancel or pursue further collections according to policy decisions at the time.

Terms of the scheme

Any bank accessing the Covid-19 SARB window and being eligible for the CLGF would have to accept the terms of the scheme.

We believe these should include:

- The Covid-19 loan scheme should be standardised across the banking industry and branded separately. It should be presented as all banks jointly working together in the crisis response.
- Banks should not pool funding. Banks can access the Covid-19 funding window individually. In doing so banks will have to provide Covid-19 scheme reporting to the Prudential Authority each week indicating volumes of loans issued and demonstrating that window funding is not co-mingled with broader liabilities.
- Banks can issue Covid-19 emergency loans using internal funding resources but equivalent funding can be accessed from the window such that the Covid-19 book is 100% covered by window funding by the end of the window period (or less if banks use cheaper funding).
- Banks' assessments should ensure the applicant meets the following conditions:
    - That their business was viable prior to the crisis. This should be supported by reviewed financial statements showing that the company was profitable in its last financial year and that management accounts for the period up to the crisis.
    - That the business plan is viable in a post-crisis scenario. This should follow from its viability pre-crisis, but specific long-term effects of the crisis should be considered in determining whether the company will be viable post-crisis. Ongoing guidance can be provided to banks in the scheme regarding the economic outlook and viability of broad classes of business activity in future.
    - That the company have no other access to funding. This should consider existing cash levels in the business and existing loan facilities. A key principle is that the Covid-19 scheme should not be an opportunity to refinance high-priced facilities.
    - That the company be up to date on all loan servicing requirements. This will be difficult to determine but banks should in the first instance ensure that the applicant is up to date on all servicing of loans that bank has issued. A further key principle is that the scheme should not be used to cure delinquent clients.
    - That the company be tax compliant.
- Banks should not be permitted to refuse an applicant that meets these conditions on other grounds, such as whether that applicant is an existing client of the bank.
- All Covid-19 loans should be standardised to the following terms:
    - Issued at prime less 200 bps
    - First year interest is capitalised
    - Repayments begin in month 13
    - Three-year term of the loan
    - A R5,000 application fee can be charged and capitalised to the loan amount. This is to cover the credit assessment process which will be resource intensive. Note that this relatively prejudices smaller clients, so a grant scheme may be appropriate for smaller clients covered by the CLGS.
    - Only the amount needed to bridge the company for 90 days should be advanced.
- A standing advisory committee for the scheme, consisting of the Prudential Authority, National Treasury, the Banking Association South Africa and two other co-opted representatives should engage with banks and advise on policy matters in the interpretation and development of these terms.

Key terms of loans issued under the scheme

Term	
Interest rate	Prime less 175 bps
Repayment period	3-years
Repayment holiday	First 12 months, during which interest and fees are capitalised
Initiation fee	R5,000 (capitalised)
Average loan size	R100,000
Maximum loan size	R100m
Anticipated number of borrowers	200,000

Loan size and take-up

Many international schemes have focused guarantee schemes on small and medium-sized businesses. However, when this is the case there is usually an alternative mechanism in place to support large businesses in distress.

In the South African case, we believe the scheme should accommodate larger businesses than the typical SME case in the absence of a specific intervention for larger businesses. The failure of larger businesses can have a multiplier effect on failures down their supply chains, which often affect many SMEs.

The size constraint should therefore be determined by the concentration risk that can be incurred by the scheme. We recommend this be capped at R100m, but this should be seen in the context of other policy interventions and resulting stress points in the economy. There were only 706 companies in SA reporting profits of R100m or above in 2017.

According to SARS statistics, in 2017 (the latest that provides a breakdown of companies by size) the number of companies and amounts of income reported were:

Taxable income	Number of taxpayers
Loss	222,821
R nil	393,623
R1 to R1m	161,390
R1m to R100m	35,611
R100m	706
Total	**814,151**

Sars estimated that in 2019 there were 2-million registered companies of which 903,320 were expected to submit tax returns.

If 200,000 applicants apply, representing 22% of all taxable companies, the average loan size would be R100,000, implying a strong bias to SMEs.

Financial effects on banks

The scheme is effectively a non-profit intervention to rescue the economy during the crisis. The benefit to banks is indirect in ensuring that the economy survives, including the many commercial and SME clients within it.

The funding costs and interest will provide a 350 bps margin for banks. On the R200bn size target, R7bn of net interest income could be earned. The R5,000 loan fee charged would generate fee income. If there are 200,000 applicants, R1bn in fee income would be generated. The costs would include:

- The administrative costs of the scheme including marketing material, loan vetting processes, disbursement, collections and administration.
- The impairments raised on the remaining 20% of the loans that stay on bank balance sheets. Assuming our 20% default rate, this implies R8bn of impairments.
- The net cash position of banks would therefore be zero, before any administration costs are covered.

This would provide a strong incentive for banks to manage credit collections to below the 20% default expectation and to keep costs to a minimum.

The economics must work to balance:

- Free rider risk. If banks perceive the benefits of the scheme to be indirect through the wider economy, then the incentive is to free ride on other banks' lending through the scheme
- Profiting on public interventions. If income margins are large banks will earn profits on the scheme which would undermine the public purpose and the cost carried by the public

Bank income could be improved by increasing the rate earned to prime less 750 bps, which would increase net interest income to R9bn, leaving R1bn available to cover administration expenses. Whether this would be appropriate depends on banks' views on the benefits of the externalities of the schemes.

It is important therefore that banks perceive the scheme to be breakeven to them. Moral suasion and bank corporate social responsibility should serve to ensure banks operate within the intended spirit of the scheme. It may be appropriate for banks to set specific loan targets to achieve in terms of the scheme, perhaps as a proportion of total assets, to limit free rider risk.

Banks currently have R1.3-trillion worth of commercial loans on their books while additionally, a portion of their retail books represent SMEs. This indicates capacity for the banks to undertake such a scheme.

The three-year proposed loan term is short. This is consistent with the emergency nature of the funding. On expiry, assuming strong enough economic recovery, banks should refinance clients into standard commercial loans.

Adaptability

The course and impact of the crisis is highly uncertain. The scheme we have outlined here caters for a considerable impact in that it envisages no cash-flow effects for 12 months. This accommodates an extended period of reduced activity.

However, the scheme can easily adjust scale and terms. The funding window period of 30 days can be extended if lockdown conditions remain in place. The loan tenure of three years can be adjusted or rolled into a new scheme if necessary. Loans granted can be increased.

The scheme can also be restarted in the event of further distress, for example as a result of a second peak in viral infection rates in a subsequent season.

The scheme is also adaptable in response to global funding options and presents a clear mechanism in the guarantee fund to access and accommodate global support that might become available.

Regulatory considerations

These are important steps that would enable the scheme, but we welcome the spirit of engagement that government has shown in taking emergency steps to manage regulatory constraints and look forward to engaging further on additional considerations.

- Exemption from competition legislation has already been granted in terms of emergency legislation, which enables banks and the SARB to work together to develop the single product and offering.
- The National Credit Act and regulations pose a potential further obstacle particularly for SME lending. Loans to businesses with a turnover of less than R1m require payslips and three months' bank statements as part of an affordability assessment. Given that the terms of the Covid-19 Emergency Loan scheme substantially replace the need for an affordability assessment and the objective should be minimising cost, it may be necessary to waive the affordability test requirement for this scheme.
- The liquidity effects of the scheme will be negative as short-term funding will be used for three-year loans. The SARB will need to accommodate this through the liquidity coverage ratio limits, perhaps with a specific carveout for the scheme, given that the CLGF will cover 80% of loans.

International precedents

We consider the United Kingdom and Brazil in some detail. To date, the following 51 countries have implemented some sort of bank loan scheme based on our analysis of IMF data: Argentina, Australia, Belgium, Bosnia-Herzegovina, Bulgaria, Cape Verde, Hong Kong, Croatia, Czech Republic, Denmark, Estonia, EU wide guarantee schemes, France, Germany, Greece, Guatemala, Iceland, Ireland, Israel, Italy, Japan, Korea, Lithuania, Luxembourg, Malaysia, Malta, Moldova, Morocco, Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Russia, Slovenia, Spain, Switzerland, Tunisia, Turkey, UAE, United Kingdom, Uruguay.

United Kingdom

The UK announced several interventions amounting to a £330bn bail-out package for the economy. These include lending schemes for both large and small businesses.

Large businesses: The Bank of England (central bank) has been tasked with making large business loans directly through the "Covid Corporate Financing Facility". Companies issue commercial paper to the central bank on terms equivalent to pre-Covid-19 market levels. The paper is government-guaranteed. Companies do not need to have issued paper before but must be investment grade-rated, which applies to only about 100 UK large companies. There is debate about extending the scheme to companies with lower credit ratings. So far it does not appear any company has used the facility.

Small businesses: The Coronavirus Business Interruption Loan Scheme provides loans to small businesses of up to £5m. Companies must have revenues of less than £45m/year. All loans are made via registered lenders which includes banks as well as some asset-based lenders and smaller specialist lenders (40 in the UK).

Loans are normal term loans, overdrafts, discounting facilities or asset finance. They interest- and fee-free for the first year (these are paid to the lender by the government).

The scheme was announced on 23 March and lenders began lending on 25 March. There have been teething problems with complaints from potential borrowers that they have not been able to get a response from their banks, but it now appears the scheme is gearing up. It is initially set to run for six months, though facilities can be for longer.

Banks can ask for personal surety from borrowers, but large banks have agreed not to for loans under £250,000.

The scheme is guaranteed by the British Business Bank, a state-owned DFI, which covers 80% of loans.

Brazil

Brazil has activated a scheme from the financial crisis that was designed for deposit guarantees to be used for credit guarantees to underpin lending by financial institutions.

The Central Bank of Brazil oversees the scheme by which loans of up to BRL2-billion (USD377m) are guaranteed by the Credit Guarantee Fund (FGC). This is expected to allow banks to increase lending by about US$37.7bn to the economy, 1.8% of GDP.

Several other smaller measures have been taken to directly contribute to bank lending growth, including increased flexibility on letters of credit and other fixed income securities that either increase bank liquidity or allow banks to expand lending.

These steps are said by the central bank to add up to USD640bn-worth of additional loans by the banking sector.

The bank has also taken further liquidity steps through relaxing capital adequacy requirements and liquidity ratios.