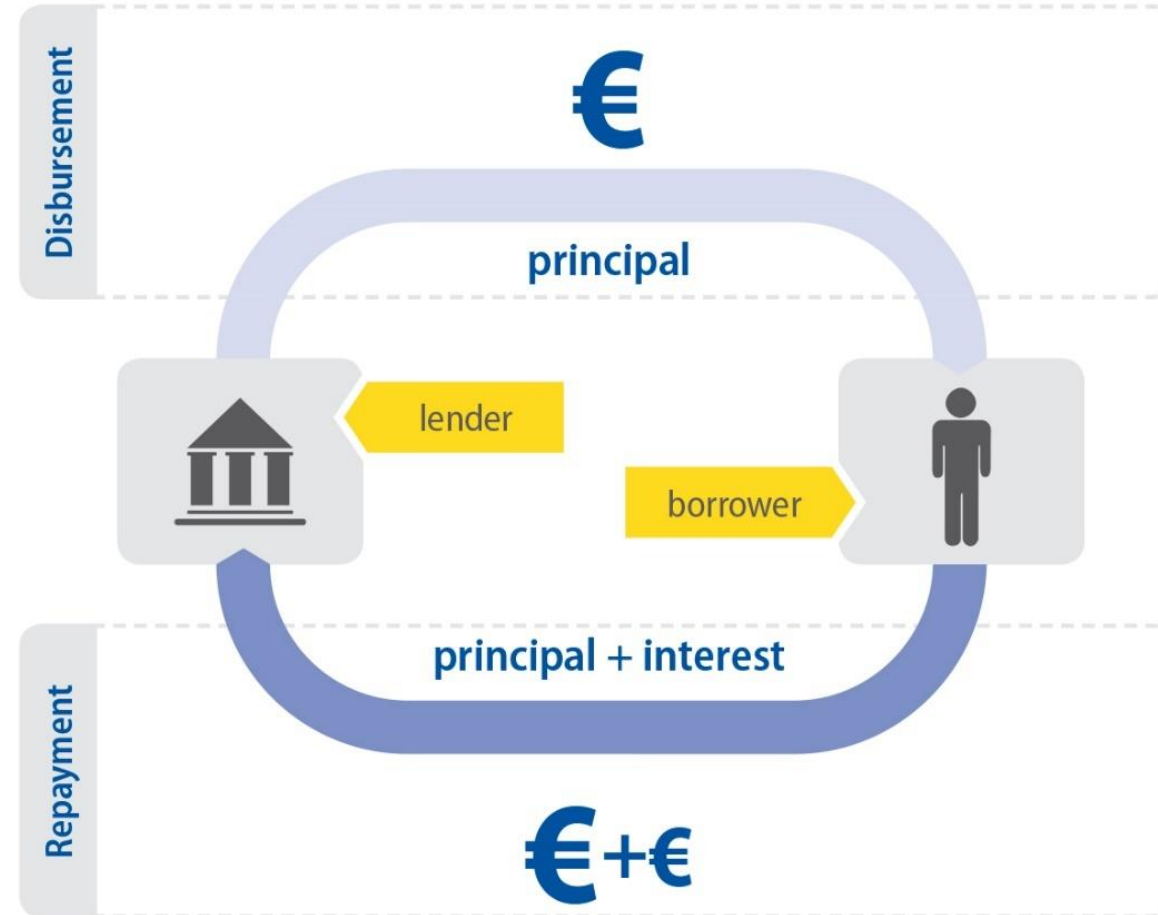




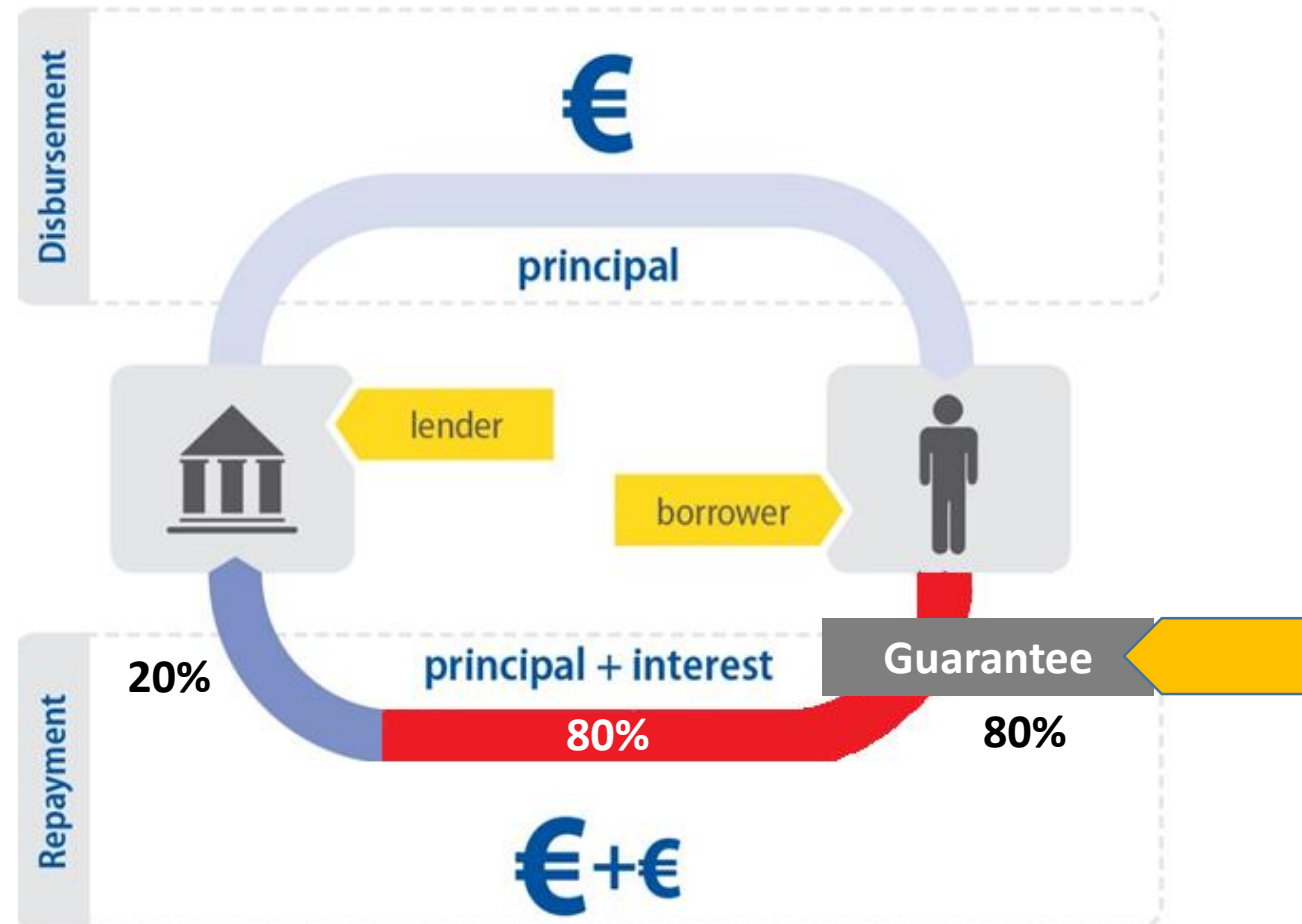
Financial instruments structures: Guarantee instruments

**Mario Guido,
EIB**

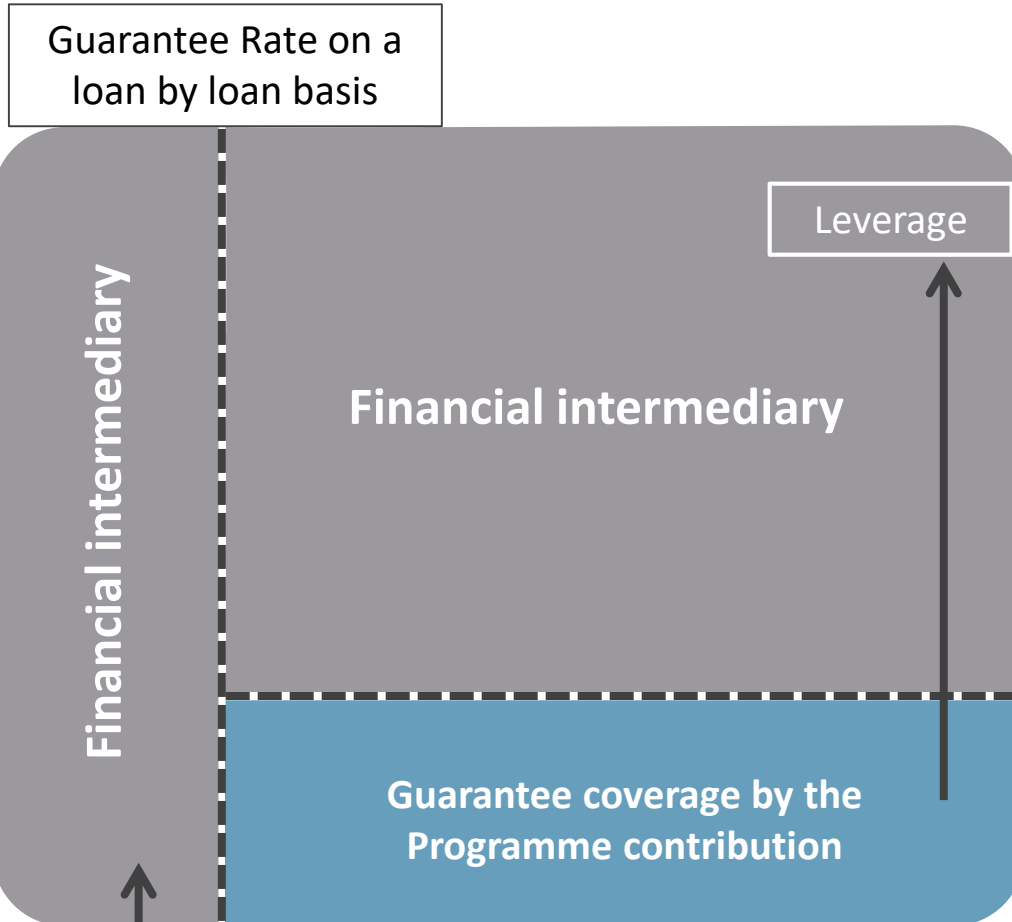
How does a Guarantee instrument work?



How does a Guarantee instrument work?



How does a portfolio guarantee work?



- When it is useful:**
- High collateral requirements by banks;
 - Risk-aversion of banks to finance riskier projects;
 - Tightening of lending conditions stemming from regulatory pressure.

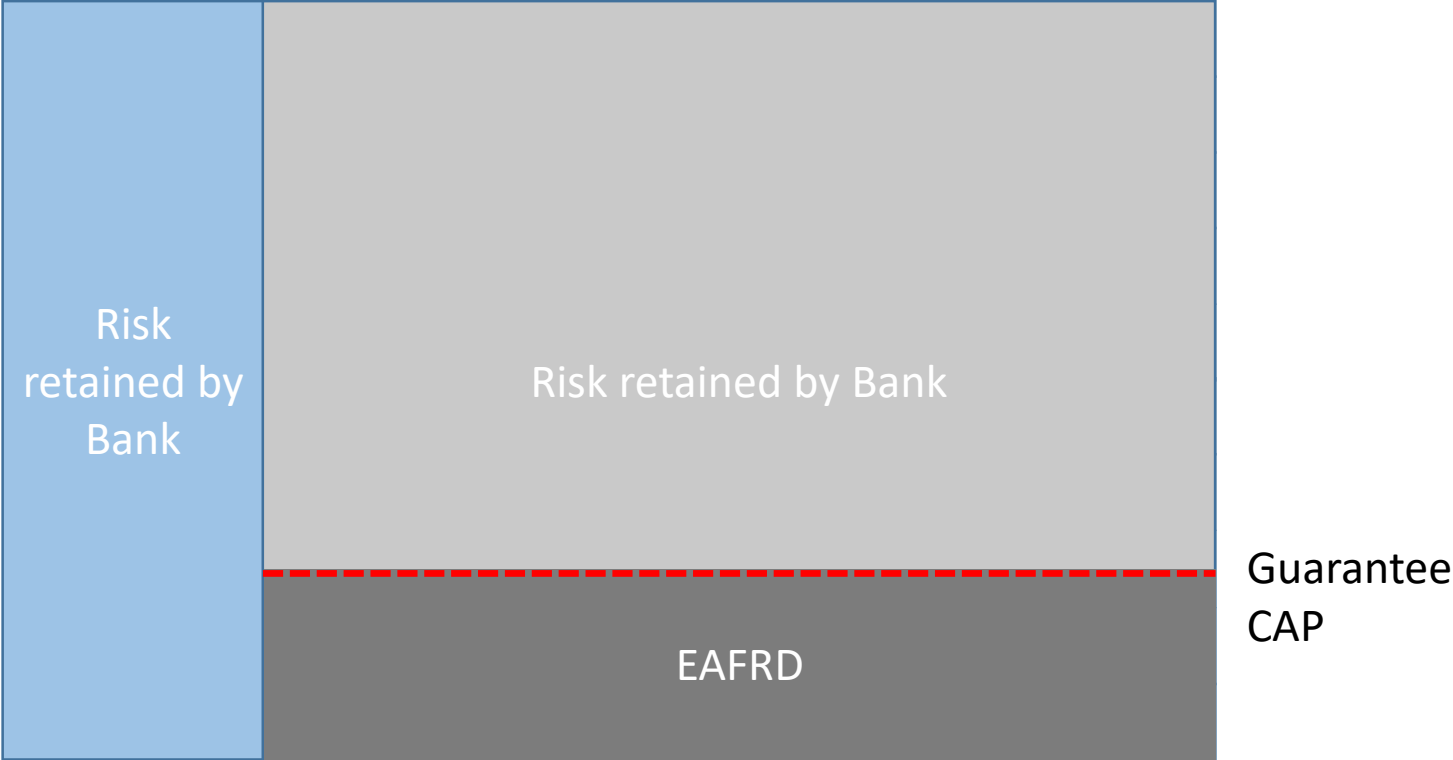
Guarantee Cap Rate



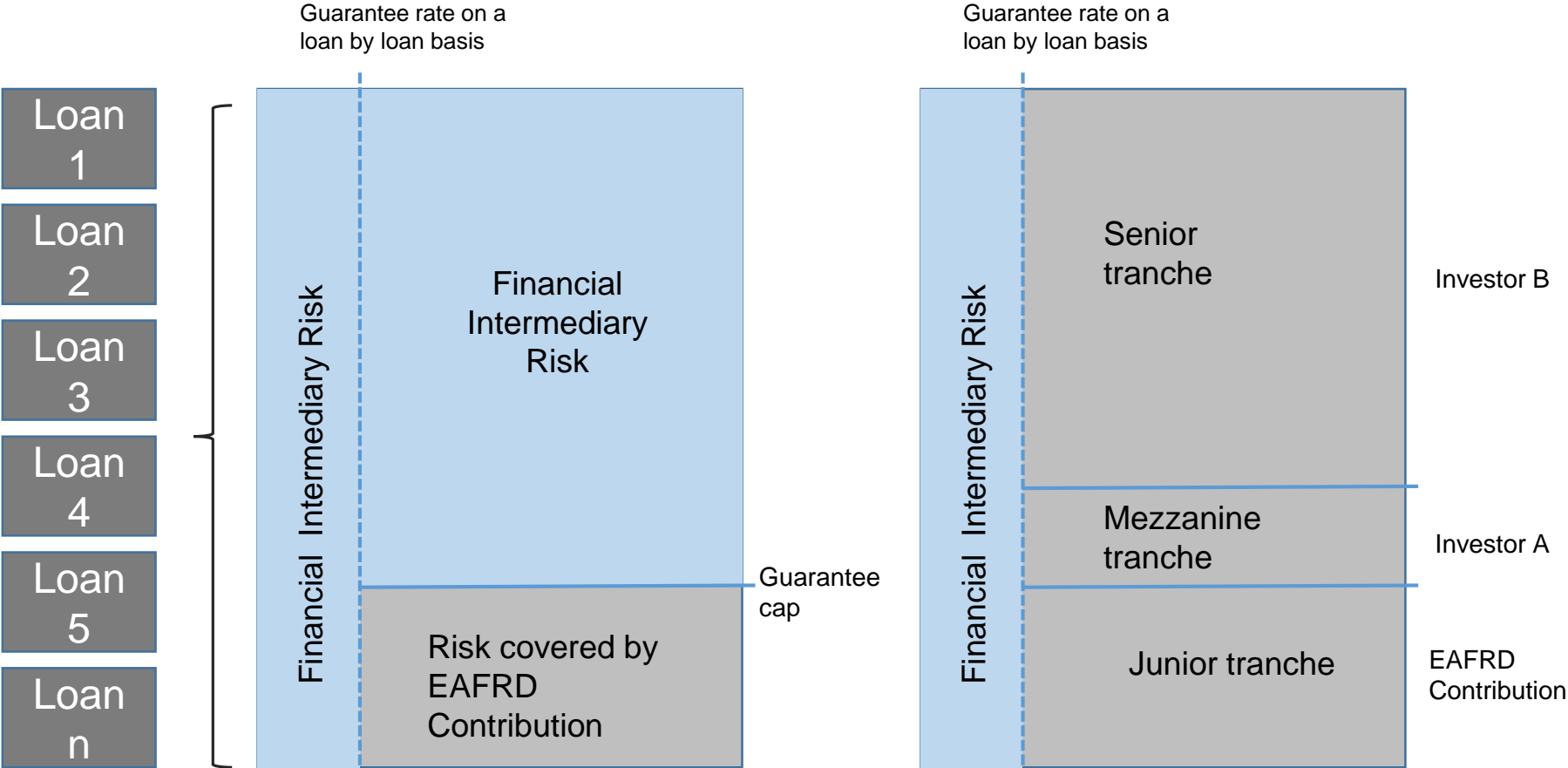
Risk retained by the financial intermediary (financial intermediary own risk)



First loss Portfolio Guarantee



Capped vs Uncapped Guarantee



Capped Portfolio Guarantee



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.

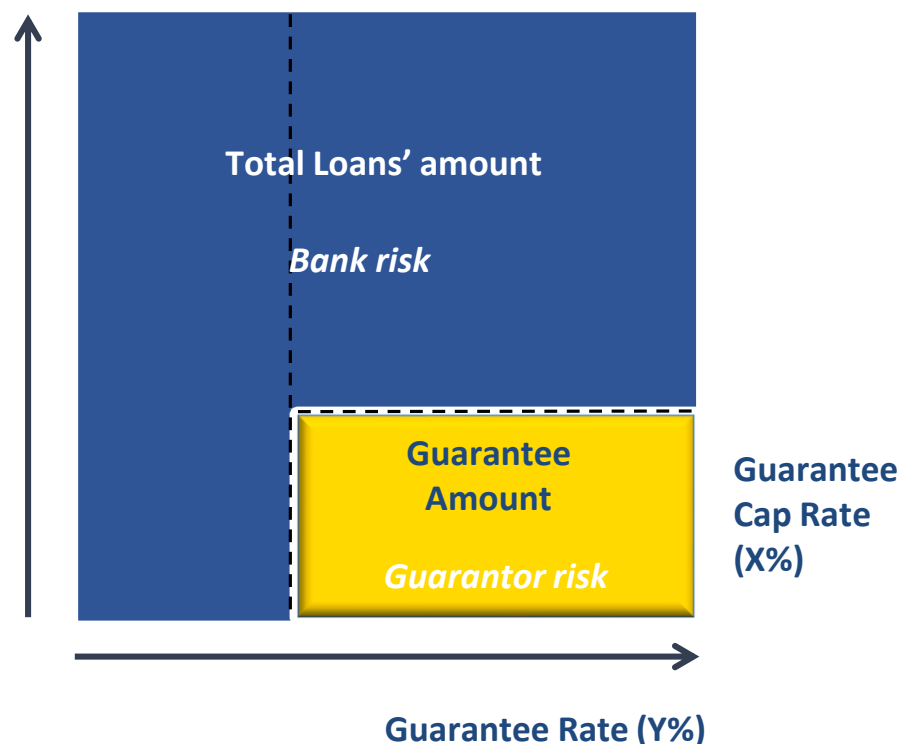
The Capped Portfolio Guarantee provides credit risk coverage to intermediaries on a loan by loan basis, **up to a Guarantee Rate**, for the creation of a portfolio of new loans to SMEs **up to a Guarantee Cap Rate**.



First Loss Portfolio Guarantee *at a glance*



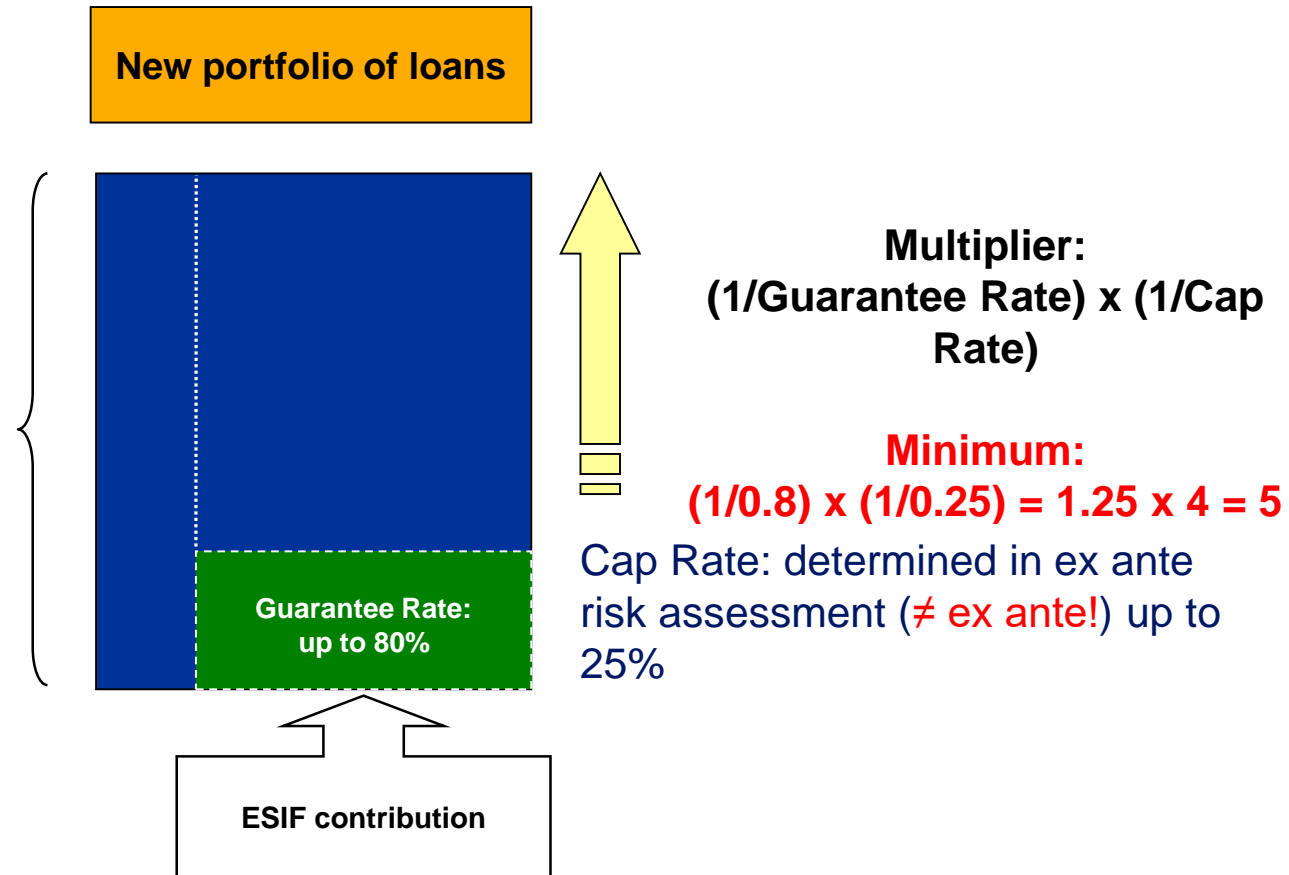
Portfolio of New Loans



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



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 1.5 million 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 investments.



Capped Portfolio Guarantee



Further key features (continued):

- 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,
 - Flnt. to always keep at least 20% of risk in its own book.

Capped Portfolio Guarantee



State aid:




- At FoF and FInt. 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*.

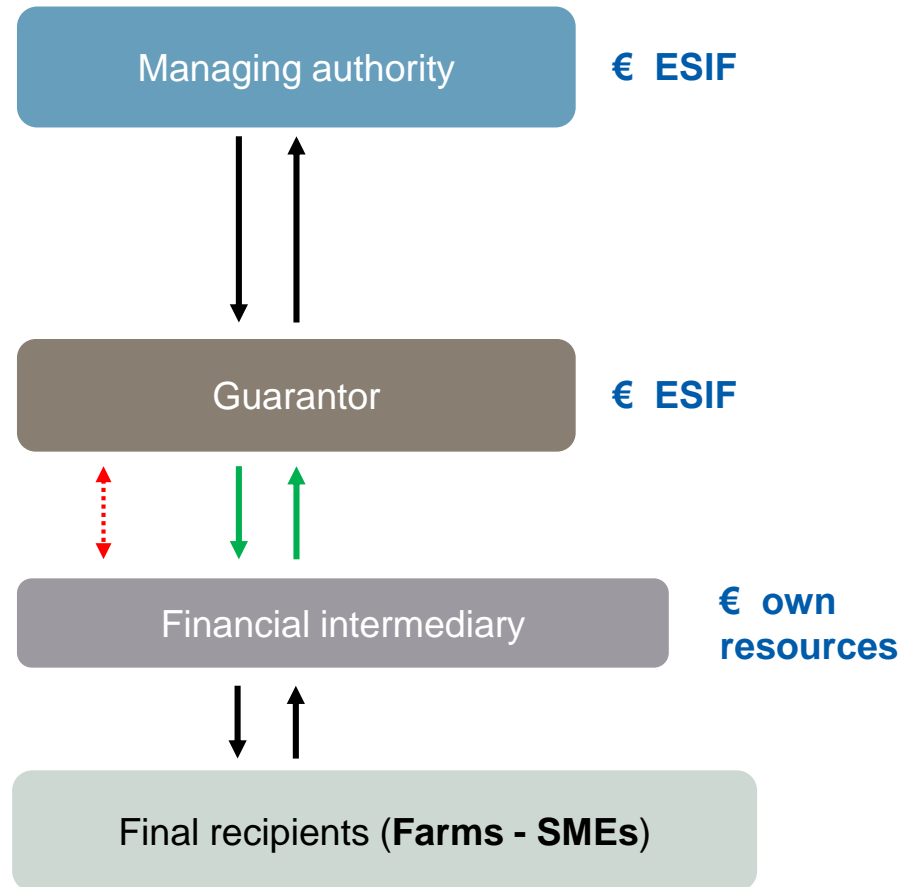


Flow of money



Flow of € guarantee:

-  Commitment
-  Payment/Re-payment
-  Default / Recovery



Capped Guarantee Instrument: What happens in case of a default?



- **Assumptions:**
 - Loan amount : **EUR 300 000**
 - GR: 80%
 - CR: 25%
 - Leverage: $1/(GR*CR) = 5$
- **Default occurred:**
 - Outstanding amount: **EUR 200 000**
 - Financial Intermediary calls the default to the guarantor
 - The guarantor pays the default in [60] days: $200\ 000 * 80\% = 160\ 000$
- **Recovery actions take place:**
 - Amount recovered: EUR 150 000 (out of EUR 200 000)
 - Part for the guarantor: $150\ 000 * 80\% = EUR\ 120\ 000$
 - Part for the Financial Intermediary: EUR 30 000
- **To conclude:**
 - Without this instrument the Financial Intermediary would have lost :
EUR 200 000 – 150 000 = EUR 50 000
 - With this instrument the Financial Intermediary has lost:
EUR 200 000 – 160 000 – 30 000 = EUR 10 000

Pricing and collateral policies

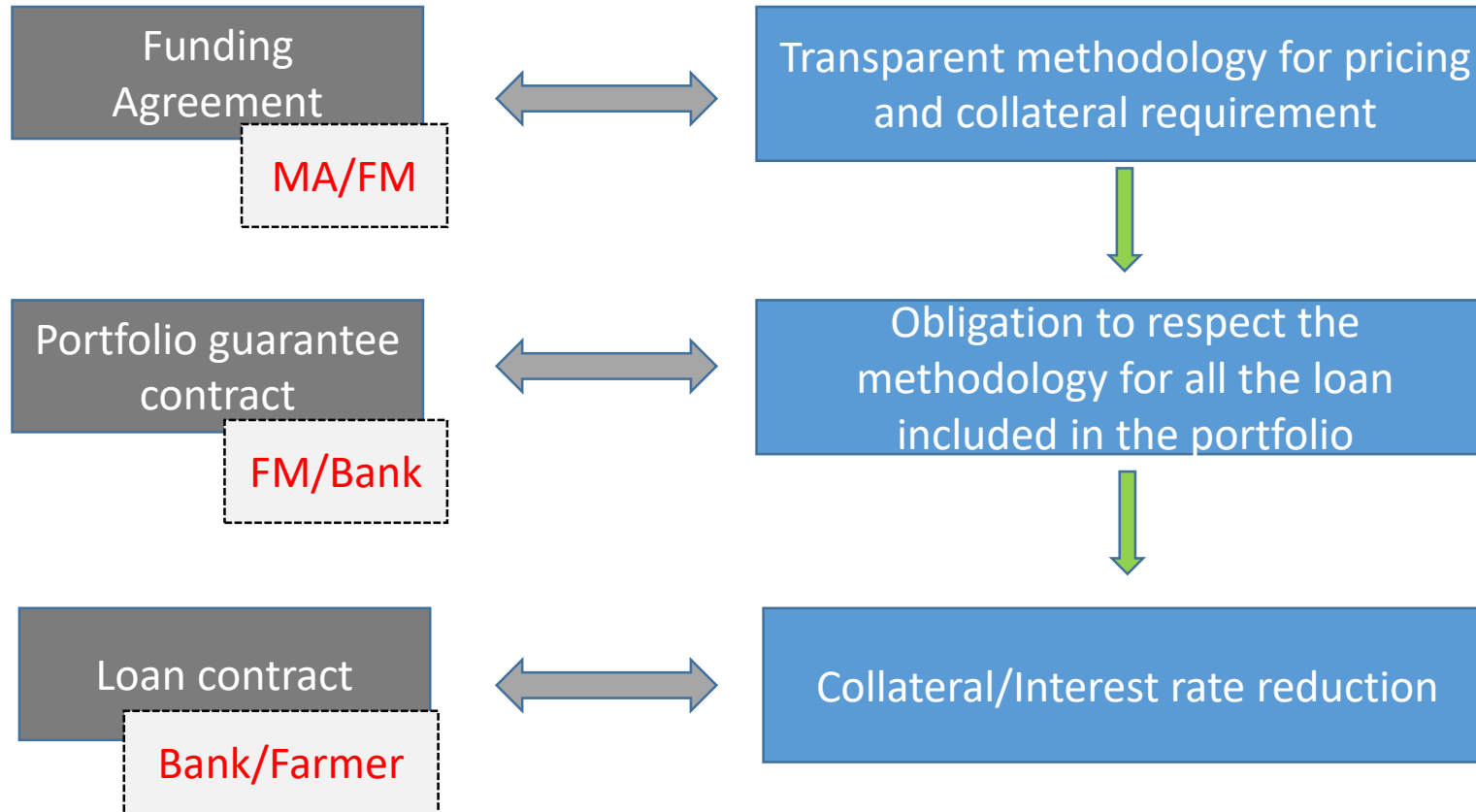


- On the basis of REG 480/2014, article 7, par. 2, when selecting a body to implement a financial instrument, the Managing Authority must assess “**the conditions applied in relation to support provided to final recipients, including pricing**”;
- The **Fund Manager is responsible for the application of a pricing policy** based on a methodology ensuring that the financial advantage of the guarantee is totally passed on to the final recipient (e.g. in terms of interest rate and/or collateral requirements reduction).
- The **methodology must be reflected in the guarantee contract between the Fund manager and the Bank and in the Loan contract**

Pricing policies flow



Pricing/Collateral Policies



Pricing and collateral: Off-the-shelf



For example, in the Off-the-shelf Capped Portfolio Guarantee scheme (Reg. 964/2014, Annex II):

- The **Fund Manager must use a methodology** that ensures the full pass on of the financial advantage of the programme public contribution to the final recipient;
- The **Bank must apply a pricing/collateral policy in line with the methodology**;
- The **Bank must reduce the overall interest rate and/or collateral requirement** under each eligible SME loan included in the portfolio following the above mentioned methodology.

Guarantee - Transfer of benefit to SMEs



FLPG

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

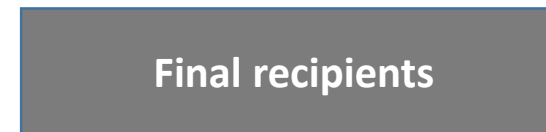
- Significantly lower collateral requirement
- Reduction of risk related margin (decrease in the interest rate)
- Decreases in fees (based on call application)



Fund manager



Banks



Final recipients

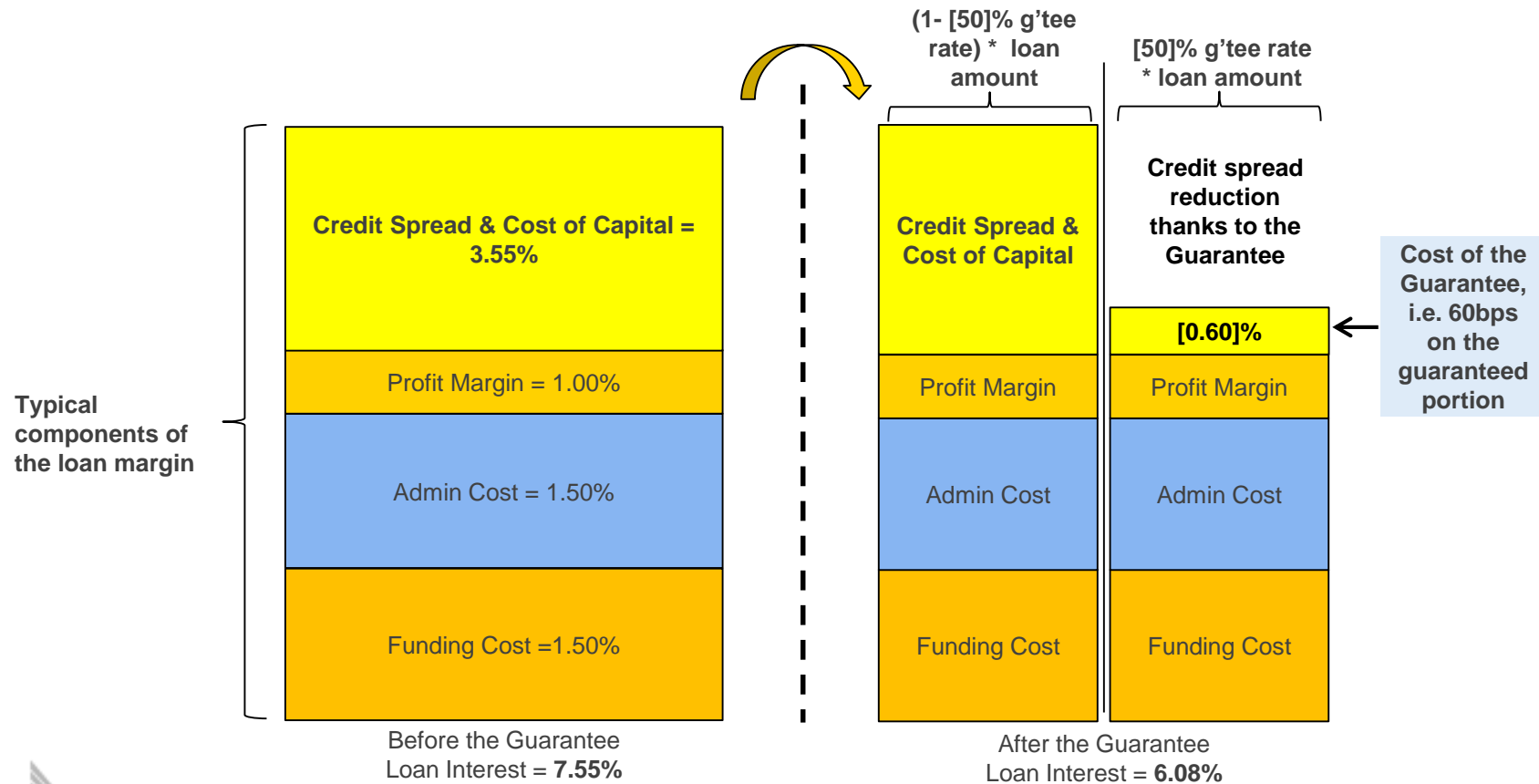
Pricing: EIB/EIF experience



- **Example of clause for funding agreement:**
 - I. In respect of the interest rate (per annum) applied by the Intermediary to each SME Transaction, the standard spread above the Bank's Base Rate applicable to the relevant SME Transaction (such standard spread being assessed at the time of the relevant loan request) shall be reduced at least by the number of basis points per annum indicated in the table below, depending on the Intermediary's internal rating applicable to the relevant SME:

SME rating	standard spread reduction (bps)
BBB+	33
BBB	44
BBB-	71
BB+	105
BB	138
BB-	158

Financial advantage passed onto SMEs (FLPG example)



All numbers are indicative and for illustrative purpose

Collateral: EIB/EIF experience



Example of clause for funding agreement:

- I. Under the relevant transaction the intermediary shall no benefit from a personal guarantee from the relevant entrepreneur or a security over any of the entrepreneur's assets of a value more than 50% of the relevant amount



Main advantages of Guarantee instruments



For MA:

- Leverage effect (> than for a loan),
- Alignment of interest (Flnt. “skin in the game”),
- Finance viable investment.

For Banks:

- Flnt. 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 Flnt. risk coverage,
- Collateral reduction,
- Interest rate reduction (cost of risk should be reduced) (< than for a loan).

Zero risk does not exist !!



- Risk analysis of SMEs is key (*whether public fund involved or not*).
- The lender will always apply its own specific **credit procedure**. Its credit procedure could be different depending on certain features of the borrower, for instance:
 - Retail segment vs. corporate segment, number of employees, turnover, loan amount & maturity requested, etc.
- According to these parameters, the decision process might be different (e.g. approval of the loan at the branch level or at central level).
- Assessment of the **creditworthiness** of the SME: specific to each bank, however some common elements can be highlighted:
 - *Capacity* i.e. the ability of the SMEs to pay back the loan, this is typically evidenced by the SME's business plan. Viable investment, cash flow to pay back the loan,
 - *Collateral* i.e. the security that the SME can provide to the lender in case of a default,
 - *Capital* i.e. the SME's own financial involvement into the project,
 - *Character* i.e. the track record of the SME (reliability),
 - *Conditions* i.e. the macro-economic context / sectorial outlook for the parties (**lender & borrower**).

