Design of a Promotional SME Loan Programme
- Key Issues for Discussion -

Norbert Irsch, Robert Kirchner

German Economic Team Belarus

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Contents

A. Background

Background

- During recent conversations, the “Development Bank of the Republic of Belarus” announced its intentions to launch and run a promotional SME loan programme in cooperation with commercial banks
- All statements and recommendations in this presentation are meant as inputs to this discussion, highlighting the main issues that need to be clarified when setting up such a scheme
- Abbreviations used in the presentation:

  DB = Development Bank

  CB = Commercial Bank(s)

B. SME-Programme: Rationale, Mechanism, Effects

- Objectives and Targets
- On-lending Mechanism: Basic features
- Effects of the Promotional Loan Programme

Objectives and Targets (1)

Analytic basis of the planned support programme:

Comprehensive assessment of

- the financial problems of SMEs in Belarus,
- the performance and deficiencies of the banking sector (in particular loan offers to SME and their major features – i.e. maturity, collateral, currency, interest rates etc.)
- the existing promotional landscape (institutions and programmes)

Objectives and Targets (2)

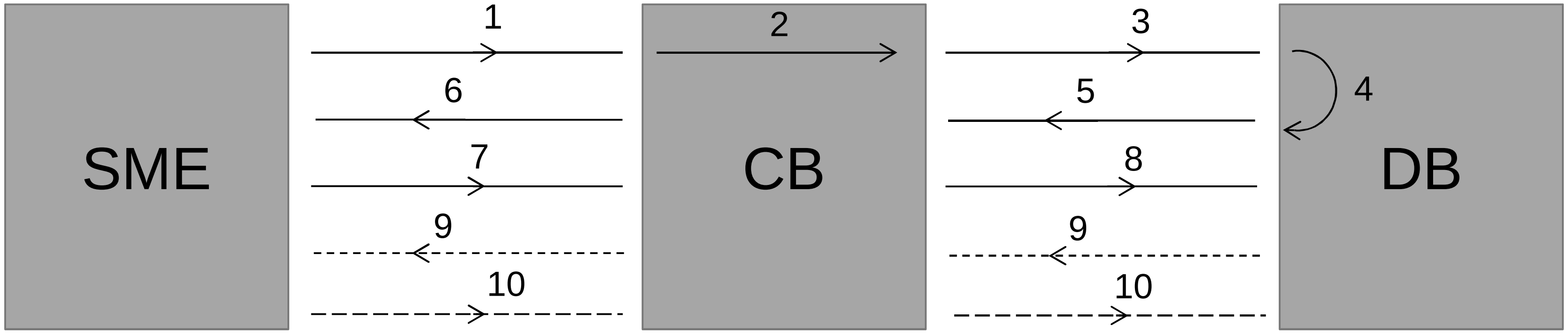
<u>(Presumptive) main results:</u>

- Activities of SME – in particular investment and innovation – are significantly suppressed by lack of available financing by commercial banks (CB). Concerning loan conditions (e.g. maturity, interest rate) SME – in particular start-ups – are disadvantaged in relation to larger firms
- Commercial banks (CB) are rationing the SME-loan demand (market failure) because
  - granting loans to SMEs is a relatively less profitable activity for them (due to relatively high transaction and risk costs), and
  - CB suffer from a lack of (long term) funding

<u>Solution to overcome these problems and deficiencies:</u>

- Development Bank (DB) establishes a targeted promotional loan programme for SME. The programme loans have advantageous conditions and longer terms. They are granted to SMEs through on-lending CB. The programme is designed up as a permanent and continuously refinanced scheme

On-lending Mechanism: Basic features (1)



Main steps:

Step 1: SME applies for a loan under the promotional programme of DB to CB

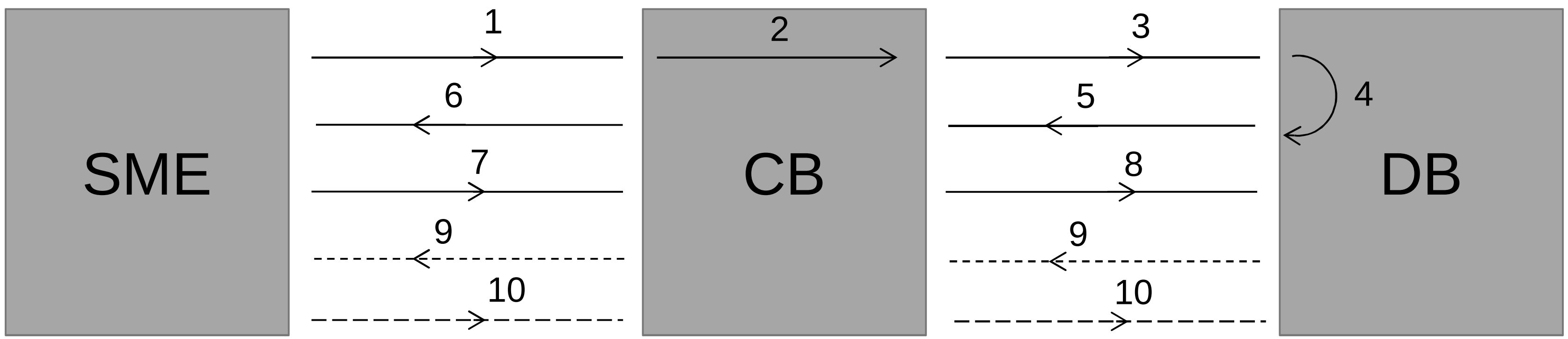
Step 2: CB checks the application for bankability(viability of the project, creditworthiness of SME)

Step 3: CB transmits the application to DB

Step 4: DB checks the loan application also for bankability but mainly for compatibility with, and conformity to the promotional programme

Step 5: PB commits the applied loan to CB with the obligation to on-lend it to the SME in compliance with the rules and conditions of the promotional programme

On-lending Mechanism: Basic features (2)



Main steps:

Step 6: CB transmits the loan commitment to the SME

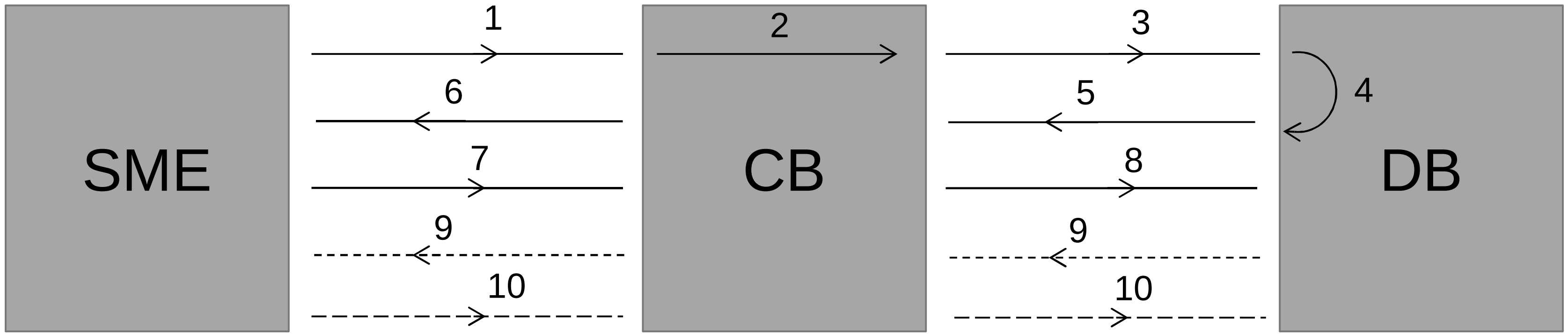
Step 7: If the conditions for disbursement are fulfilled, the SME calls the loan from CB

Step 8: CB transmits the call to DB

Step 9: Disbursement flows from DB to SME via CB

Step 10: Interest and amortization payments flow from SME to DB via CB

On-lending Mechanism: Basic features (3)



<u>Two principles control types for on-lending transactions</u>:

1) CB is authorized to commit individual credits up to a maximum accumulated loan amount (limit of CB). This limit depends on the max. risk that DB accepts with regard to CB.
2) DB concludes a loan agreement with CB. CB is authorized to on-lend out of this loan individual credits to SME up to a specified accumulated amount (tranche). The individual credits are checked by DB ex-post before the next tranche is released.

<u>Crucial success requirements</u>:

1) DB does not compete with CB (no crowding -out)
2) On-lending rules and conditions are in principle the same for all on-lending CB, independent of their ownership (state/private)
3) End user (SME) rules and conditions do not differentiate between SME

Effects of the Promotional Loan Programme

<u>Main effects</u>:

- SME access to finance at affordable conditions is improved. Investment and in particular innovation activities (and possibly energy-savings) of SME (including start-ups) will rise
- SME-sector competitiveness, its export performance and GDP-growth will be strengthened
- Sustainable jobs are created

<u>Side effects</u>:

- In general, commercial banks will be induced to finance SME. Their respective know-how and technology will be improved.
- Inter (commercial) bank competition will be intensified. The conditions of the promotional programme provide a transparent yardstick for attractive loans to SME. Market transparency will be improved.
- The orientation of commercial banks towards the provision of <u>long-term</u> financing will be enhanced

C. Major Structural Features

- Rules and Conditions: Final User (SME)
- Rules and Conditions: On-Lending Banks
- Selection Criteria for On-Lending Banks
- Risk Position of the Development Bank: Summary

Rules and Conditions: Final User (SME) (1)

- **SME eligible to apply**: All enterprises (all branches, including liberal professions) domiciled in Belarus, who do not employ more than 250 employees
- **Investments eligible for financing**: All investments that require (medium-term or) long-term funding. The necessity of financing also working capital (generally, or only for specific activities) should be examined
- **Financing volume**: Financing share (loan amount/investment amount): up to 2/3, Investments under EUR 1 m up to 80%
- **Maximum loan amount**: up to EUR 5 m; **Minimum loan amount**: € 1000
- **Currency**: Local currency (BYR) / Potentially foreign currency (EUR, USD) for exporters
- **Maturity**: Maximum loan term 5 - 10 years. Grace period (for repayment): Not more than 1 – 2 years
- **Repayment**: From the end of the grace period in monthly or quarterly or half-yearly instalments. During the grace period, only interest on the disbursed loan amount has to be paid
- **Collateral**: Customary banking security e.g. land charge, transfer of ownership (of machinery), guarantees. Details of collateral will be negotiated between the SME and the CB.

Rules and Conditions: Final User (SME) (2)

<u>Interest rate: Fixed or variable interest rate?</u>

- As SMEs, and in particular start-ups face a relatively high business risk and taking into consideration that generally SME are not very sophisticated in financing, the promotional loan should be simple and provide financing certainty.
- Therefore a scheme with fixed interest rates (fixed for the entire term of the loan) is in principle preferable. Off-schedule repayments with a respective fee should be possible.
- The interest rate should follow market rates and be in the lower spectrum of the market to be attractive. Interest rate should be fixed on the date when disbursement is requested.

<u>Subsidization of the promotional loan programme</u>?

- If the government (budget) provides the necessary funds, the programme loans may be further subsidised. Technically, subsidies can be provided in different ways: 1) Interest rate subsidy, 2) Amortization grant, 3) Investment grant.

Rules and conditions: Final User (SME) (3)

Other conditions:

a) Refinancing, or ex-post financing of projects already finished is excluded

b) Disbursement 100%. Disbursement must be requested within a specified period after the date of loan commitment by PB

c) Commitment fee for DB (e.g. 0.25% p.m., starting one month after commitment date) on the undisbursed loan amount gives an incentive to rapidly request full disbursement

d) Management fee for DB (e.g. 0.15%, lump sum) on the loan amount as compensation for incurred fixed costs

e) Final borrowers should adhere to international standards against money-laundering and corruption

Rules and Conditions: On-Lending bank (1)

Programme Interest rate/on-lending margin (OLM):

- End-user interest rate = CB refinancing rate (charged by DB) + on-lending margin (OLM)
- The OLM is set by DB and is equal to all CB
- To give CB an incentive to cooperate in the promotional loan programme, the OLM must cover all on-lending costs of CB (e.g. costs of handling final users and their applications, transaction-plus risk-costs) and a moderate (substandard) profit margin
- Furthermore, the OLM should be set by DB as a maximum margin to give individual SME (that are less risky or have less risky projects) the chance to negotiate a smaller effective OLM and thus a lower interest rate. Only the maximum programme interest rate for end user is fixed by DB. The OLM should – if at all - very seldom be altered.

Rules and Conditions: On-Lending Bank (2)

- When specifying the size of OLM, DB has to bear in mind two further sources of CB`s profit generated by on-lending:
  1) Not only OLM, but also the improved chances for CB to acquire with the backing of on-lent promotional loans new clients/business
  2) When fixing the programme OLM, DB has to take into account the average cost efficiency of all on-lending CB. By increasing its cost efficiency connected with to on-lending, an individual CB can achieve an above-average effective OLM, respectively a higher profit. This mechanism is a significant incentive for CB to strengthen cost efficiency.
- The direct and indirect profit incentives of on-lending for CB reduce its propensity for cherry-picking, i.e. CB finance very sound SME/projects with own funds (outside the programme) and on-lent only to SME with average or weaker bankability

Rules and Conditions: On-Lending Bank (3)

Primary risk/Collateral:

- In the standard case, CB bear completely the risk that a borrowing SME doesn´t service repayment or interest claims. Thus, if a SME doesn`t honor its payment obligations, the CB must step in and pay to DB. This provision creates for CB a strong incentive to thoroughly scrutinize the bankability of the end user and their projects.
- If DB wants to provide access to programme finance also to particularly risky projects or enterprises (for example start-ups or innovation) it could grant CB a partial relief from full primary risk, i.e. DB assumes a part (e.g. 50 %) of the risk. However in this case a part of the OLM will be transferred from CB to DB
- By default (as standard) CB have to assign receivables and collateral to DB. Thus, DB is shielded from a default of CB and a simultaneous default of the final borrower and CB.

Compliance:

- CB (and of course PB) have to adhere to international standards of honorable banking (e.g. anti-money-laundering, anti-corruption)

Selection Criteria for On-Lending Banks

In principle, all commercial banks domiciled in Belarus are eligible for on-lending under the promotional loan programme. The concrete choice by DB must be based on objective criteria that allow a judgement on CB`s performance and business model. The most important ones are:

- Creditworthiness- and solvency-criteria: e.g. leverage ratio, capital adequacy ratio (CAR), structure of liabilities
- Liquidity-criteria: short-term and long-term liquidity
- Profitability, Structure of Profit & Loss account, structure of costs, sources and volatility of earnings
- Organisational and operational structure (e.g. are they apt to sustainably and efficiently on-lend?)
- Prior experience in SME-lending (e.g. through IFI-funded programmes), sufficient personnel for SME-lending, competence of staff and management in SME-business

Risk Position of the Development Bank: Summary

- If the on-lending margin (OLM) is sufficiently attractive, the incentive of CB for cherry-picking (i.e. financing „better“ SME outside the promotional programme) is small
- By default, the primary risk fully has to be shouldered by CB. The on-lending banks are selected on the basis of objective solvency and quality criteria. Thus, the risk of unprudential and poor conduct of CB in bankability-/creditworthy-checks of projects/ SME and is not significantly higher than in the banking sector in general
- In case DB will give CB an additional incentive to on-lend to certain target areas that bear high risks, or are particularly desired by policy (e.g. innovation, start-ups, energy savings, etc.) a partial exemption from primary liability can be granted to CB. This will increase DB`s risk. It can be curbed or covered by shifting an appropriate part of the OLM from CB to DB and – if necessary – to increase the OLM for on-lending to these areas.
- If a CB defaults, DB is shielded by CB`s assignment of receivables and collateral. If a SME defaults, the CB has to step in and fullfill the SME`s obligations. If SME and CB coincidentally default, DB is shielded by the collateral provided by CB.

D. Control and Supervision

- Controlling the Final Demand
- Controlling the On-Lending Channel
- Monitoring
- Evaluation

Controlling the Final Loan Demand

- In principle, DB can control the end-user demand for programme loans by all parameters which affect the attractiveness of the loans
- Those parameters however, whose variation causes relatively high implementation costs/reduce the transparency of the programme/encounter high reluctance should not be used for continuous control
  - Such parameter are e.g. maturity, grace period, repayment modalities, on-lending margin
- Practically only rationing (of the offered loan volume), marketing and interest rate variations are suitable for control-purposes
  - Rationing bears the disadvantage to increase uncertainty and therefore to induce inefficient demand decisions and market results („first come, first served")
  - Marketing is a very cost-intensive instrument. Because of its relative slow impact, it is not suitable for day-to-day modifications of credit demand and has the further handicap of relative uncertain effects
  - By altering the programme interest rate, the volume of end user demand can be modified smoothly and frequently. Furthermore, this control instrument entails rather low implementation, adjustment and communication costs

Controlling the On-Lending Channel

- The maximum on-lending volume of a CB is fixed by its on-lending limit (set by DB), respectively the volume of a loan agreement between DB and CB. CB can create additional free limit by providing additional collateral to DB or by strengthening its solvency.
- The ability of a CB to on-lend depends on the capability of its respective organizational and operational structure. DB can offer assistance to build up these structures or to improve their efficacy.
- Training the personnel of CB is also a means to strengthen its efficiency and maybe readiness in on-lending
- An effective, but biased instrument to influence the propensity to on-lend is the on-lending margin (OLM). An increase would be welcomed by CB, whereas a squeeze faces strong resistance and has the potential to damage the on-lending channel in a sustained manner.

Monitoring

- DB must be able to inform at short notice e.g. the government, the public (media) or the business community on the programme and its impacts
  - In regular time intervals, it should issue monitoring reports informing:
    - On the credit volume extended, planned Investment, jobs to be created, possibly energy savings planned (e.g. broken down by SME-size, branches, regions, credit-size)
    - On basic characteristics of the SME promoted by the programme (e.g. turnover, employees, sector, profit, balance sheet total, equity and other balance sheet components)
  - The monitoring should cover indicators of the on-lending performance of the CB (e.g. loan volume on-lent, speed of on-lending transactions, is its on-lending biased with respect to loan size, sectors, risk?). Also, potential „cherry-picking“ or the effective OLM should be monitored.
  - (The continuous surveillance of solvency, liquidity and of the on-lending limits is necessary anyway)
- The data processed in the monitoring should be collected via the CB and integrated in the standard application procedure. Alternatively, they can be collected by DB directly, in a separate procedure. But: Higher costs for DB.

Evaluation

- In larger intervals (3 to 5 years), the programme should be evaluated, in order to assess its effectiveness and efficiency, to find out its strengths and weaknesses, and to improve it.
- Actual results of the programme effects (e.g. jobs created, investment realized, energy savings achieved) are necessary for a thorough evaluation. They have to be compared with the planned effects at the date of loan application.
- An important issue is the question whether the actual effects would have been realized without using the promotional loans („dead-weight effect“).
- The evaluation-studies should be done by independent research institutions

E. Communication

– Documentation
– Marketing

Documentation

- An excellent documentation – simple, slender, self-explanatory, complete – is an important „technical“ condition for the success of the loan programme
- It should contain forms for all standard communications between SME, CB and DB, and thus mirror the communication flows of the entire on-lending mechanism (see slides 6-8).
- DB should seek to establish a documentation that allows to a large extent a purely paperless electronic standard communication. As far as possible, the forms should not only be available as hardcopy, but also on-line as electronic forms apt for down-loading or on-line-handling of the procedures (e.g. fill out, transmit, commit, call).
- Representatives of the CB and the SME-community must closely be involved in the development of the documentation. Its functionality has to be tested thoroughly before implementation.

Marketing

- Efficient marketing of the loan programme is a prerequisite that the programme is country-wide known among the target enterprises.
- Marketing is important for creating steadily growing demand, even if the CB do not actively or only reluctantly offer the programme loans.
- DB should aim via targeted marketing to trigger demand pressure, i.e. SME requests to the CB to provide them a promotional loan. The stronger this pressure, the higher will be the on-lent credit volume at any OLM set. Therefore, intensive marketing is also a potential instrument to squeeze the (maximum) OLM, without reducing CB`s propensity to on-lend.
- Marketing a successful loan programme is also an effective means to enhance and enlarge the reputation of the DB. This again strengthens its autonomy.

Contacts

Robert Kirchner

kirchner@berlin-economics.com

Dr. Norbert Irsch

norbert.irsch@googlemail.com

German Economic Team Belarus

c/o BE Berlin Economics GmbH

Schillerstr. 59, D-10627 Berlin

Tel: +49 30 / 20 61 34 64 0

Fax: +49 30 / 20 61 34 64 9

www.get-belarus.de

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