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Researching Capital Markets and Financial Services

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The R200bn bank guarantee scheme isn't working. Some ideas on how to fix it.

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The ZAR200bn guaranteed loan scheme is a crucial centrepiece of "phase two" of the economic response to the Covid-19 crisis and is now one month old. Take-up, however, has been low. While numbers are a moving target, depending on how it's measured (facilities granted vs drawn down, etc), we estimate that less than ZAR2bn, or 1% of the scheme target, has been committed or disbursed. Elsewhere in the world, schemes have been calibrated on the run at a very rapid, front-loaded pace, to ensure they meet their objectives. It is important for this to be done in SA too.

Intellidex proposed a design for the scheme[1] that influenced the final policy conception. We now consider what changes would be appropriate to the deployed design.

Background

South Africa declared a state of disaster on 15 March and subsequently entered a stringent lockdown on 26 March 2020 that dramatically disrupted economic activity. While some economic measures were taken at the time to relieve the economic impact, including tax holidays and some grant schemes, a more comprehensive economic response package with ZAR500bn of interventions was announced by President Cyril Ramaphosa on 21 April. Included in this figure was a ZAR200bn loan guarantee scheme to enable banks to lend to businesses suffering from Covid-19 related distress.

Intellidex had developed a [detailed proposal] for such a scheme, that was influential in the final design of it, although the final policy design that was implemented differs in important aspects.

Finalisation of the details of the scheme and contractual arrangements between National Treasury, the Reserve Bank and the seven banks that would be using it, were concluded only by 11 May, at which point banks began to offer such loans to their clients. Loans were made available to companies with a turnover of under ZAR300m and could be used to cover overheads only.

[1] We detailed the design in a paper produced in conjunction with the Covid-19 Economists Group, available here: https://covid19economicideas.org/2020/04/13/bank-guarantee-scheme-to-bridge-finance-the-economy/

However, a month later, the take up of the loans has been small. While figures are changing every day, our inquiries with banks indicate that less than R2bn, or 1% of the target, has been lent to date.

Revisions to the scheme's final policy design are clearly urgently needed in order to ensure the full ZAR200bn is deployed rapidly and the concomitant stimulus felt in the economy.

Reasons for low take-up

No systematic study has been undertaken into companies' or banks' reasons for the low borrowing and lending volumes so far, though we are aware of plans for systematic surveys by some organisations.

However, a picture is emerging of the obstacles to greater take-up on both the supply (banks) and demand (companies) side from an accumulation of anecdotal feedback. These have informed the views we present in this section, though we acknowledge more research is needed.

Demand side constraints

Various factors affect businesses' appetite for the loans, both because of the rules of the scheme and because of businesses' own risk management objectives.

We consider each of these below.

1. Too late

The guarantee scheme became available only about seven weeks after the lockdown took effect. By this stage, companies with minimal reserves would have been forced to furlough or retrench staff and eliminate other expenses such as cancelling rental agreements or otherwise starting the process of renegotiating such commitments. Of note, companies went through two month-end periods (of wages, rent etc) with no support – other countries such as the UK generally deployed such schemes rapidly at mid-month, before a month-end cycle and with a less than one week time lag from announcement to activation. A substantial source of demand was therefore no longer present at the point the loans become available.

The need is not in dispute. Banks' own forbearance measures, through which they granted payment holidays or similar support, show this. Our research of the five largest banks (including Capitec) show that forbearance has been granted on R495bn of loans and were generally front loaded in the crisis, equivalent to 15% of the entire loan book of those banks. That indicates the demand for credit support that had existed earlier on.

2. Reduced risk appetite

Although the loan terms included a six-month payment holiday and subordination to all other debts (ranking with equity in a liquidation), business owners would naturally want to reduce financial risk in their businesses in light of the crisis and severe uncertainty it has caused. This would involve reducing financial liabilities wherever possible, rather than taking on additional liabilities that could increase a businesses' financial risk. For many businesses facing the choice between closing down and taking on additional financial risk, closing down will be the optimal choice.

Some anecdotal feedback Intellidex has garnered suggests that those businesses that have successfully obtained facilities in terms of the scheme are not drawing down on those facilities because of this risk.

3. Price (interest rate)

The interest rate at prime, while low historically, may well seem high for SMMEs facing an existential threat like Covid-19. Equally, social distancing in the long run affects profit potential and the debt-carrying capability of firms into the future, which can make the rate seem high.

With the uncertain pace over the speed of reopening the economy, as well as a potential second wave of the pandemic next year, the six months interest free period may well also be too short. It will mean interest rates kick in in Q4, exactly when social grant payment step-ups stop and UIF support will have ended. For a tourism company, say, which may not expect to reopen before Q2 2021, this is problematic. Overall, we think these price effects decreased demand.

4. Lack of flexibility on the use of proceeds

The loan scheme is specified for overheads such as rent, payroll, debt service costs and other fixed costs. This obviously restricts businesses in the flexibility they would otherwise have in using the proceeds – and reduces demand. The restrictions also create perverse incentives – it can incentivise companies to try not to reduce rent, even when they should as they prepare for a viable post-Covid-19 future. Restrictions on dividends and shareholder loans

The scheme prevents businesses from paying dividends or shareholder loans while they hold the loans (though this has been applied differently by different banks according to our research). As the crisis began, many businesses would have reduced dividends while others contributed shareholder loans during the lockdown period. Taking the loans prevents them from recovering this forgone income and reduces flexibility, especially for SMMEs which are more likely to be reliant on these kinds of loans to fund personal commitments of owner-operators.

5. Requirement for personal surety

Related to the risk aversion we should expect in the face of an economic crisis, some banks have asked business owners to post personal surety for any loans provided.

The crisis is characterised by deep uncertainty. However, the principle of the government guarantee is that it aligns some of the risks with the issues that government can control, particularly the details of what parts of the economy can operate and when. This control is beyond that of businesses or their owners, so the addition of risk to owners is inappropriate and undermines one of the main risk characteristics of the scheme: that government is taking on the risk of the existential threat to the economy as a result of the pandemic response. As such this seems to be an unnecessary component.

6. Limited eligibility of businesses

According to some feedback we have received, businesses are being considered ineligible by some banks if they are part of a group of companies, or have a majority shareholder that is not a natural person or trust. This naturally reduces the number of eligible businesses. Our original analysis pointed out that there were 900,000 tax-paying companies in South Africa, of which up to 200,000 should be eligible for loans. The limitations on eligibility substantially reduces that number.

Supply side constraints

Various aspects of the scheme's final design reduce bank appetite to lend in terms of it.

1. The guarantee fails to increase bank credit appetite

The guarantee should have the effect of limiting bank balance sheet exposure. It should reduce the expected loss given default and the provisions that banks are therefore required to make. The 94% guarantee (less the interest margin earned each year) places a cap on the maximum loss banks could face.

However, the scheme rules specify that banks must apply their standard credit risk assessment processes. National Treasury has the right to audit any loan should the guarantee be called and would presumably refuse to pay on the guarantee should it find that normal credit risk processes were not applied. This means that the 94% guarantee has **no effect on bank risk appetite** as, by design, any increased bank appetite invalidates the guarantee.

This is a major design flaw in the scheme which means it fails to achieve its primary objective of improving bank appetite to lend into the economy during a period of crisis. Put very simply – the point here is that there is greater credit risk in the system which needs to be lent into – if that isn't happening, then incentives are not right.

As we propose below, a much narrower risk assessment framework should be specified and only that be potentially audited.

2. Bank systems and processes provide limited flexibility

Banks have reported challenges in adapting application processes specifically for the scheme, especially at speed. This means even if risk appetite were affected by the guarantee, this would not result in lending occurring.

3. Lack of profitability

The scheme is designed so as to break-even for banks. The benefit to banks should come from the improved credit outlook for clients given that the scheme loans rank behind existing loans which clients may hold. However, the lack of proximate profits on the scheme inevitably means that banks will direct resources to other more immediately profitable activities – which may include holding SA government bonds, given market volatility.

4. Fiscal accounting

An indirect constraint on the supply side stems from the way the scheme is reflected in the fiscal accounts. In the first R100bn phase, the guarantee is provided by National Treasury. This forms a contingent liability on its balance sheet. There is, however, no budget for how much treasury actually expects the scheme to cost. There is no target amount that will cover defaulting loans. Therefore, there is no targeted risk appetite to be pursued.

We think this is crucial – in such a risk environment the risk of the guarantees being called must by definition be greater than zero – if it isn't, then the scheme is not doing what it is meant to.

Treasury has said the second ZAR100bn tranche will be made available depending on demand, and that this may include a fund specifically to cover losses. This seems to be an odd play on optics when the whole point of the ZAR500bn stimulus plan is the deployment of all of it, front loaded as much as possible in this fiscal year.

In our initial proposal, we said a 20% default rate should be set as the anticipated losses on the scheme. This is far higher than banks' commercial books as they stand. Banks would take the minor proportion of this loss with the government taking the major portion. We originally proposed that a fund that raised concessionary finance should be established to absorb this loss. Treasury has indicated that expedience dictated that the fund should only be set up for the second R100bn tranche.

From government's perspective, however, a contingent liability should, as a matter of policy, be something that it minimises to the furthest extent possible – yet losses here need to be thought of as maximal and real. Without a specific budget for losses, government cannot calibrate its risk appetite, which means it cannot enforce on banks that they calibrate theirs.

The consequences

The ZAR500bn package was welcomed by economists as a very important intervention to limit the economic damage of the pandemic and the lockdown.

Our forecast for this year is that GDP will decline by 10.4%. However, this anticipates that the ZAR 500bn package that has been promised is actually delivered. In our models, the ZAR 500bn package contributes almost six percentage points of GDP. Without it, the decline would be 16.4%.

The ZAR 200bn scheme is 40% of the package, but has a higher economic multiplier effect than the other elements. We had pencilled in a 1.3 times multiplier for the scheme, reflecting that it could fund further economic activity.

Looking at the fiscal multiplier impact of the ZAR500bn package.

Item	Amount ZARbn	Share of GDP %	Multiplier x	Impact ppGDP
Loans	200.0	3.9	1.3	5.1
Health	20.0	0.4	1.2	0.5
Grants	50.0	1.0	0.5	0.5
Unemployment benefit	10.2	0.2	0.5	0.1
Food parcels	0.1	0.0	1.0	0.0
SMME	2.0	0.0	0.7	0.0
Revenue measures	70.0	1.4	0.6	0.8
Jobs	100.0	1.9	0.5	1.0
Municipalities	20.0	0.4	0.8	0.3
Other	27.7	0.5	1.0	0.5
Reprioritisation	-130.0	-2.5	1.1	-2.8
Average/Total			**0.8**	**6.0**

It follows that 5.1 of the 6 percentage points stem from the bank guarantee scheme. Without it, on our models, the GDP growth outlook is substantially weaker at around -15.5%.

This is clearly a far worse economic outcome and is precisely what the ZAR500bn package was intended to avoid.

Fixing the scheme

There are several measures that would improve its effectiveness in terms of increased volumes and speed of disbursal.

We believe these should be done immediately given risks of tighter lockdowns in metros to come, but also with an eye to a second wave in the middle of 2021.

1. Remove restrictions on the use of proceeds

If a restaurant or hair salon wants to use the lockdown period to remodel, let them – it will create employment. There are also costs to adaptation to social distancing which should be open to coverage here. If we want the recovery post the lockdown to be robust, freeing businesses to spend the loan proceeds as they wish would enable them to invest in preparation to resume activities. And while preparing they would be consuming goods and services that support other economic sectors.

Furthermore, proceeds could finance businesses to adapt to selling during the lockdown. For example, if a retailer wants to use the money to build a website to enable ecommerce, this should be encouraged, not restricted.

2. Remove restrictions on paying dividends or shareholder loans

Many company owners use dividends as a basic remuneration tool. Many also gave up dividends or loaned money to their businesses during the lockdown. The loan terms effectively prevent them from being able to pay themselves.

It is unclear what this restriction is meant to achieve. Company law already prevents directors from paying dividends if a company cannot afford to. While some loans require companies to meet certain equity ratios that has the effect of reducing equity payouts, it should be fundamental to the loan scheme that it accepts higher than "normal" risk. Imposing such covenants on borrowers should be excluded in this risk appetite.

3. Remove the cashflow structure

The current scheme pays out the principle in three tranches in the first three months. It follows from the above two considerations that this is an unnecessary cashflow restriction and should be replaced with a 100% facility available to clients to be drawn down as needed.

4. Lower the cost, extend the term and possibly fix the rate

Loans are currently priced at prime and repayments kick in after six months. This is a function of the funding window that the SARB provides to underpin the scheme which is priced at the repo rate. Naturally, a reduction in this cost would increase demand, particularly as repo rates have been reduced as part of the monetary response to the crisis. A reduction of 100 basis points on the cost of funding to reduce the cost of loans to 100 basis points below prime is feasible – it would maintain the pricing above SARB's highest priced windows (standing repo, which is currently at the policy repo rate). The reference to prime currently reinforces the "tyranny" of prime in the banking system which has no basis except precedent.

We would further propose that rates be fixed. This would make the repayment obligations certain for borrowers and reduce the fear that future rate increases pose a major risk. While prime rates are at 60-year lows, potential borrowers would naturally fear that these will increase – especially if borrowers think about mean reversion and how unusual it is to have rates this low. Consideration could be given to the SARB providing term repo facilities longer than one year to support longer fixing. These are not unusual from other central banks, though so far, the SARB has only provided repo funding less than a year.

We would further recommend the repayment holiday be extended to 12 months, with interest capitalised in order to prevent a compounding of cliff edge risks in Q4 in the economy more generally (including grant payment step downs etc) but also given the fact the economy may not fully open until into Q1 2021.

5. Create an explicit budget for the scheme

The public finance aspects of the scheme mean it is difficult for government to signal its risk appetite appropriately. The R100bn guarantee on the first phase of the scheme forms a contingent liability on the balance sheet of government, and there is no budget to cover cash calls in terms of the guarantee. We would propose that a medium-term expenditure framework appropriation is made in the emergency budget specifically for this scheme. This could be done above the line, but not department tied, through the contingency reserve line item. This would add to the fiscal credibility of the framework and provide transparency.

6. Adjust the size restriction

Currently, companies must have a turnover of below ZAR300mn. We understand that some banks have additionally specified that companies cannot be subsidiaries but must be held by natural persons. This latter restriction is unnecessary.

Any ceiling should apply to a total group of companies not any individual subsidiary. The exact level of ceiling can be calibrated according to volume, but also other policy interventions that are available at different size points. The economic response has so far not included any mechanism to support large companies that may collapse. We therefore propose that the ceiling be removed, but that loans to any company above R500m require explicit approval from the minister of finance.

7. Set an explicit credit vetting procedure

Treasury should set an explicit credit assessment procedure for the banks. Instead of insisting on a "normal" credit process, it should insist that its own process is followed given these extraordinary times. The PA should provide guidance notices on the requirement to use this.

This should require:

1. That the applicant company demonstrate it was cashflow positive in its financial accounts and management accounts up to end-February 2020.
2. That its ability to repay the loan is assessed on the assumption that the three months to February amount to normal trading conditions, and these will resume after the repayment holiday period.
3. That the company is tax compliant and fully up to date on all debt obligations as at end-February 2020 (but, importantly, any missed payments post that date be ignored in the credit assessment, where a company has shown it has entered into correspondence with SARS, even if the issue has not been resolved).
4. That no debt:equity or other leverage ratios be considered.

Conclusion

The bank guarantee scheme can and must form a critical component of the government's response to the crisis. It has the potential to provide five percentage points of GDP growth to the economy at this crucial time. It can rescue companies and jobs while driving economic behaviour. We urge all relevant parties to work together in a collaborative and innovative spirit in the public interest.

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