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18 February 2021

Assessing the effectiveness of the Loan Guarantee Scheme

A post SONA review

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Executive Summary

In the State of the Nation address last week, President Cyril Ramaphosa directed National Treasury to look at invigorating the Loan Guarantee Scheme (LGS) but did not provide any specifics. In this note we assess the deployment of the scheme and the prospects for reanimating it.

The LGS, at ZAR200bn, was the single largest plank of the government's ZAR500bn Covid-19 stimulus package announced in April, yet only about ZAR18bn of credit has been extended so far. The rate of lending growth has been declining and given that lack of momentum, the scheme is now largely moribund. This experience is like many other countries that created guarantee schemes, in that they fell far short of targets and the rate of growth has been slowing.

With a second Covid-19 wave only just behind us and further risks of additional lockdowns (either hotspot or widespread) until a vaccine is widely distributed in South Africa, the need for future support for businesses (and particularly SMMEs) needs focus.

The initial phase of LGS was effective at providing tail risk cover for banks in that they were protected from substantial default rates should the credit environment have deteriorated. Compared with voluntary credit support offered by banks, LGS has done "ok" in that context, though not in in the context of the headline size announced. The lesson from international examples and from inspecting the South African scheme is that speed, design and incentives are critical, and the South African scheme was found wanting on all three elements (partially corrected in July). The headline R200bn target was always unrealistic given the size of the small business sector that was targeted.

There are further design tweaks that could improve the performance of the scheme. As we describe below, these should include reduce suretyship requirements, wider allowed uses for proceeds, increased cover by the guarantee (remove the 600-basis point first loss buffer faced by banks), an explicit budget set for losses in national accounts, an upfront commitment to targeted loan volumes by banks and potentially lower interest rates. However, there needs to be development of quite different schemes that help companies to reduce their financial risk if we are to deliver financial solutions to stimulate the economy rather than bridge finance businesses through lockdowns, as the LGS was designed to do.

To achieve wider stimulus, schemes would need to crowd in offshore and onshore guarantees from development banks. Reform processes such as Operation Vulindlela to work across government on a range of reforms (such as loosening the regulatory burden under the NCRA for SMME lending affordability criteria, looking at technology-driven solutions that can be deployed rapidly at scale, changing PFMA and MFMA to allow greater provincial and municipality support). All this is probably too complex to implement in the short run, but amendments can be undertaken so that there can be faster responses next time.

In a constrained fiscal environment, maximum leverage from the private sector to support business (SMMEs in particular) is crucial. The LGS provides the government a path towards supporting the economy through 2021 and on to the recovery, both by reforming the scheme and introducing different schemes that better meet the needs of the economy.

Disclosures

This research report was issued by Intellidex (Pty) Ltd.

Intellidex has been actively involved in the public debate on the LGS since before its inception in South Africa – starting in March when, globally, similar schemes were being developed. Intellidex published several research papers on the topic.

Intellidex however has not been commissioned or paid any renumeration by the government, banks or any other party related to the LGS, its formation, policy making or design processes through this period. As such Intellidex believes it is not conflicted in the production of this assessment.

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1. What is the current design of the LGS and why?

There is something of a "de facto" vs "de jure" problem with the implemented (and subsequently tweaked) design of the LGS.

The original intention was to provide bridge finance to small and medium-sized businesses through the lockdown. The need to do so was recognised by many countries and more than 50 introduced some form of bank lending scheme.

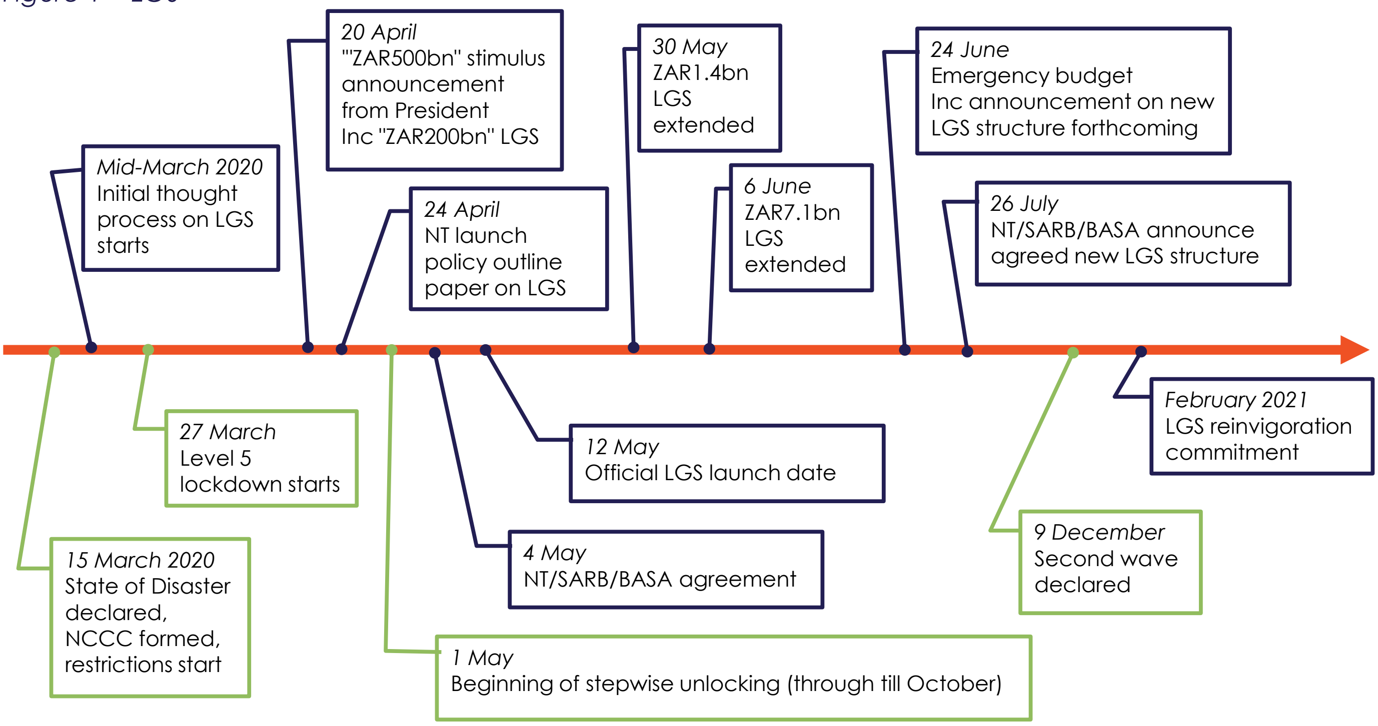
Banks would not be able to provide the necessary finance under "business as usual" conditions, because:

- The crisis meant bank balance sheets faced several risks including sharp deterioration of the credit performance of clients and reduced new business generation because of the lockdown.
- Liquidity risks increased due to potential disruption in the payments system and clients withdrawing (particularly long-term) funding as a precautionary move to protect their own liquidity.
- Visibility on future earnings was poor and banks had to prepare for possible impairments of capital, and therefore take negative, procyclical actions in reducing lending into the market.

In order to drive banks to provide bridge finance for businesses, they needed a way to move risk off their balance sheets and to access liquidity.

As we outline, the scheme provided a mechanism to do this, but as events unfolded it became clear that banks did not face a sufficiently negative credit or liquidity environment for the scheme to be used extensively.

Figure 1 – LGS



The implemented design was the result of two months of detailed negotiation between BASA, NT and SARB, though there was a wider and vibrant debate on going on over the design from mid-March (to which we contributed, see our proposal here).

At the end of July, certain design changes were made in an effort to improve the functioning of the scheme, which we review below (we recommended changes in advance of this, see here).

The final legal agreement reflected the following design:

- Commitments signed of ZAR67bn (only, not ZAR200bn) between the SARB and banks.
- An initial facility of guarantees up to ZAR100bn by NT (expandable to ZAR200bn over time, if needed) that met the scheme criteria.
- The offer of liquidity at repo to banks from the SARB.
- Clearly prescribed terms, eligible clients and credit assessments.
- A 50bp point "credit premium" charged by National Treasury on each loan.

Conditions for qualifying borrowers included:

	Original design	**July changes**
Credit history	Must be in good standing (up to date on all debt and tax payments, cash flow positive) as at end-February 2020.	Must be in good standing as at end-December 2019.
Use of proceeds	Only for overheads such as rent, payroll, debt service costs and other fixed costs. Couldn't be used to pay any dividends or shareholder loans.	"Salary-like" drawings by owners now included in use of proceeds. Restart loans included – use proceeds to facilitate reopening post lockdown.
Eligible companies	Turnover below R300m. Evidence of Covid disruption.	Maximum loan size of R100m, no turnover restriction. Evidence of Covid disruption.
Company type	Registered companies held by natural persons.	Sole proprietorships explicitly included.
Collateral	Security, suretyships and guarantees required of company directors (some banks included non-shareholder directors).	Banks free to require or not require security, suretyships and guarantees.
Credit assessment	Full normal bank credit assessments must take place.	Banks can use discretion on required documents, for example on bank or financial statements, were required.

Loan features were:

	Original design	**July changes**
Interest and payment holiday	Three months after final drawdown.	Six months after final drawdown.
Drawdown period	Equal amounts per month for three months.	Equal amounts per month for six months.
Liquidation ranking	Subordinated – ranked with equity.	Subordinated – ranked with equity.
Interest rate	Prime.	Prime.

The guarantee functions as follows (as we understand it – the contracts between SARB/NT and the banks have never been made public):

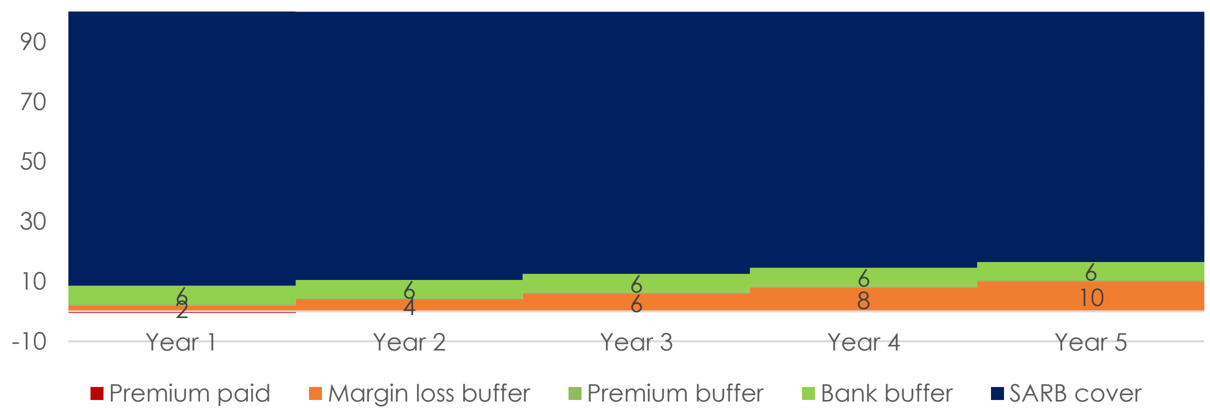
- SARB/NT can audit any loan that is claimed under the guarantee to ensure full compliance to the terms and conditions.
- In the event of loss, buffers would be absorbed in the following order:
  - The collateral held against the loan.
  - The net margin of the loan portfolio (approximately two percentage points per year, after some capital, administration and statutory costs) is pooled as the first loss buffer.
  - The 50 basis-point credit premium charged by National Treasury is the next loss buffer.
  - The lending bank takes the next 600 basis points of losses on the portfolio of the scheme.
  - Any profits held by the SARB on its own balance sheet would absorb losses.
  - After that, losses would be borne by Treasury.
- Banks posted the portfolios as collateral against the liquidity drawn from the SARB to support the scheme.
- Banks were required to use their full credit collection methodologies (and costs) to collect on the loans even if they claim on the scheme.

2. What worked, what didn't, and why?

Supply side issues

This design meant that, in practice, banks would benefit from the scheme only if 8.5% of the portfolio defaulted in the first year, with an additional 200 basis points each of the following years – i.e. 10.5% in year 2, 12.5% in year 3, and so on. This is represented in the figure below.

Figure 2: Buffers for loan defaults (SARB cover kicks in at cumulative losses of between 8.5% and 16.5% default level, depending on the year)



Banks' appetite depends on their perceived economic returns. While the design of the scheme was premised on a level of social solidarity, the underlying economics will guide behaviour, especially in the long run.

The following factors were important to banks' willingness to use the scheme:

- Risk of a rejection of the guarantee claim. Given the requirement, at least before the July change, that banks apply "normal" credit criteria, there was legal risk that claims could be rejected on the basis that banks did not fully apply their normal credit assessments.
- Cost of the scheme. Banks were required to pay 50 basis points for a loan to be covered by the scheme. Additional costs are both tangible in the form of systems changes to be able to distribute the loans, recovery costs in the event of default, and intangible in use of management time.

- The financial effect of this is that the bank is paying a premium for an option to put the loans to SARB (which in turn recovers the cost from NT). The payoff structure is not quite linear – the bank effectively recovers the 50bp premium after 2% of the portfolio has defaulted, but beyond that the option is only "in the money" at cumulative default levels, as indicated in Figure 2.
- A bank would prefer to make a LGS loan if the perceived probability of default was higher than the SARB cover levels shown in Figure 2:
  - A default equivalent to the margin buffer (2% per year) would trigger recovery of the premium.
  - Thereafter the payoff only kicks in after the additional 6% buffer paid by the bank.
  - All told, the bank would only benefit from holding the option if the expected loss given default (i.e. loss after recovery of collateral) is going to be more than the buffer level in each year. That is, they will only buy the option if they expect it to be "in the money".
- A further factor is that the loans would rank behind existing loans to clients. Therefore, LGS loans would conceivably improve the credit worthiness of existing clients, providing an indirect source of yield to the bank in the form of lower default rates on their existing books. This could in theory be measured and added to the overall yield banks may determine they receive from the scheme, but is complex to estimate and in our experience, few banks considered this as a source of return.

Given the high level of uncertainly about the outlook at the start of the loan scheme, banks may have been sufficiently uncertain to want the option of the scheme in case credit performance was particularly weak. However, as visibility on credit performance improved in the market, banks gained certainty on the outlook and therefore the probability that the LGS scheme would be in the money.

As it happens, the credit performance of the market has been relatively benign. In financial results reported in June, the credit loss ratio (the amount set aside to cover defaults in the year as a percentage of loan books) among the big four banks ranged from 1.69% to 2.77%. In retail and business banking books specifically, the CLR range was 3.77% to 2.60%. The outlook for the sector of the market focused on by the LGS probably falls close to this average (perhaps marginally higher given that banks must be blind to the financial performance of the businesses after December 2019).

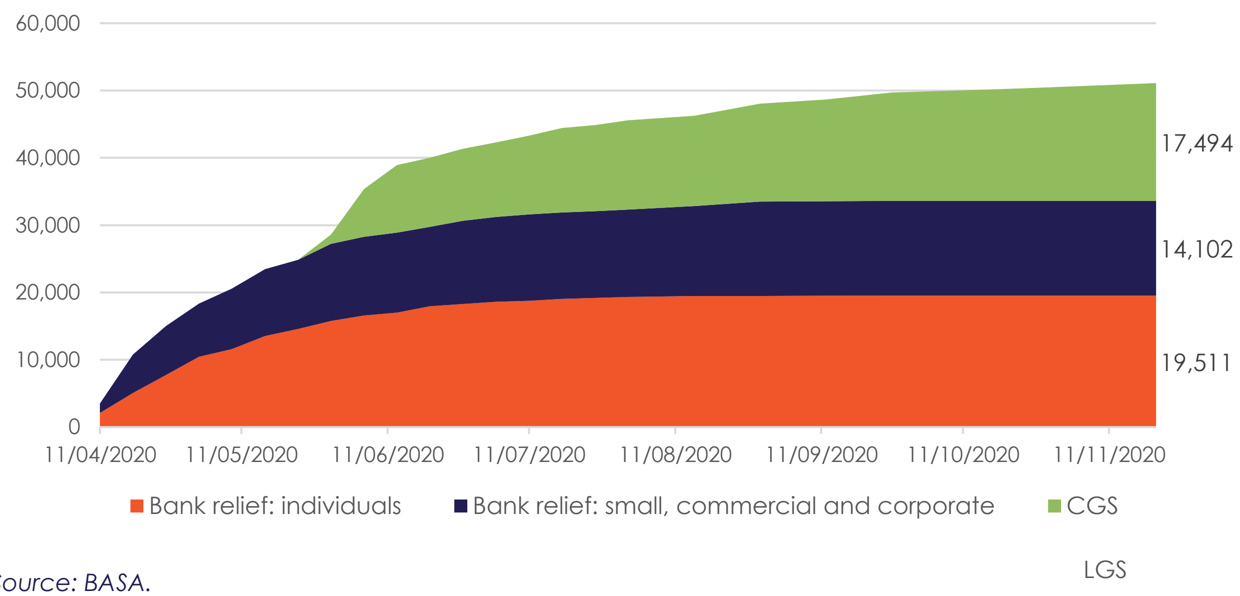
It is also important that, because of the IFRS 9 accounting standard, banks are required to raise provisions for their books up front, so CLRs were high this year but that won't repeat. It may be the case (and recent GDP figures would support this) that the environment improves faster than was expected then, and banks can write back some of the provisions into their earnings. It is likely that CLRs in future will be significantly lower than this year, less than the 200bp annual accumulation of buffer in the LGS scheme.

The bottom line is, post the initial weeks after lockdown, few banks would have believed the LGS scheme would deliver any economic value to them. As a result, they were better off writing loans to clients with unhedged exposure to their own balance sheets than using the scheme.

In a way, this was not by accident. The design of the scheme deliberately minimised the chances that the NT guarantee could ever be called. It was a contingent liability, not a specific budgeted amount that NT had set aside to cover expected losses. At best, the scheme removed tail risk facing banks of a serious deterioration in the credit environment, but it quickly became apparent that risk would not materialise.

It is also important that the scheme came into the market late. This had both supply and demand side effects. Banks had already undertaken significant forbearance measures with clients including payment holidays and loan restructurings. These had been more effective in the crucial time for bridging the lockdown. Indeed, the extent of the forbearance measures undertaken by banks surprised us, with between 15% and 23% of the books of the big four banks subject to some level of forbearance, representing several hundred billion rand of loans.

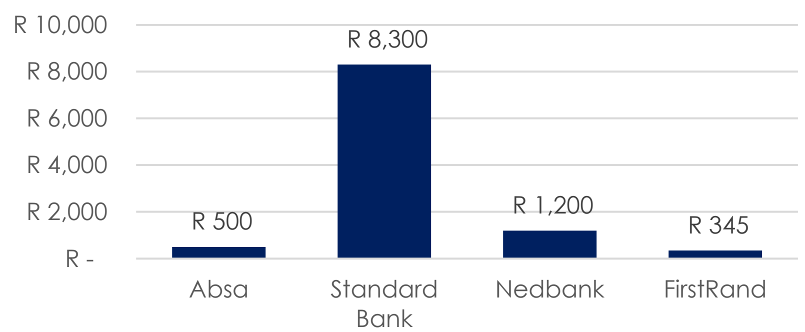
Figure 3: Covid-19 relief provided by banks since mid-March 2020 to November (ZARmn)



Source: BASA.
Note: figures on bank forbearance only available up to 26 September 2020 – assumed not to have grown beyond that. Bank relief figures represent cumulative cashflow relief.

Figure 3 shows the mix of forbearance and LGS loans. Forbearance figures are in the form of cashflow relief to clients (from lengthening loan terms and payment holidays). The LGS scheme did initially bump up the support in the market, but this tapered quite quickly.

Figure 4: LGS loan volumes per bank as at June 2020 (ZARm)



However, it is notable that there was a stark variation in the amounts lent by the different banks (Figure 4). These figures are those reported by banks for their June 2020 financial results, the last available bank-level figures. The general arguments above on the economics of the scheme clearly don't explain this. Based on our conversations with the banks, the stand out performance of Standard Bank reflects the fact that it quickly adapted its systems so that LGS scheme loans were able to be distributed through its normal channels rather than a more manual workaround that other banks used. The differential indicates, however, that better deployment of the scheme could have been achieved had all the banks matched Standard Bank's deployment strategy.

An important take away from the supply side discussion is that **just because the scheme wasn't used, doesn't mean it did not serve its purpose.** The scheme was effectively an insurance policy. It would have been used much more by banks had the credit performance of the economy been substantially worse and would thereby have contained the financial and economic shock. This reading is solid when the scheme is considered in its initial purpose of bridge financing the economy, rather than the alternative purpose of stimulating the economy.

Demand side

The policy was announced on 21 April and the facility was launched on 12 May, though the first recorded loans from banks were not extended until the week of 30 May, with the bulk then extended in the first half of June. Subsequently, the scheme was amended in the middle of July (after the end-June emergency budget) to loosen the criteria. This did not lead to a meaningful rise in LGS loans being extended (shown in Figure 3).

There are three main groups of explanations:

- The unattractiveness of the loans to potential borrowers.
- General risk aversion that had arisen in the market.
- The small scale of the potential market.

Unattractiveness

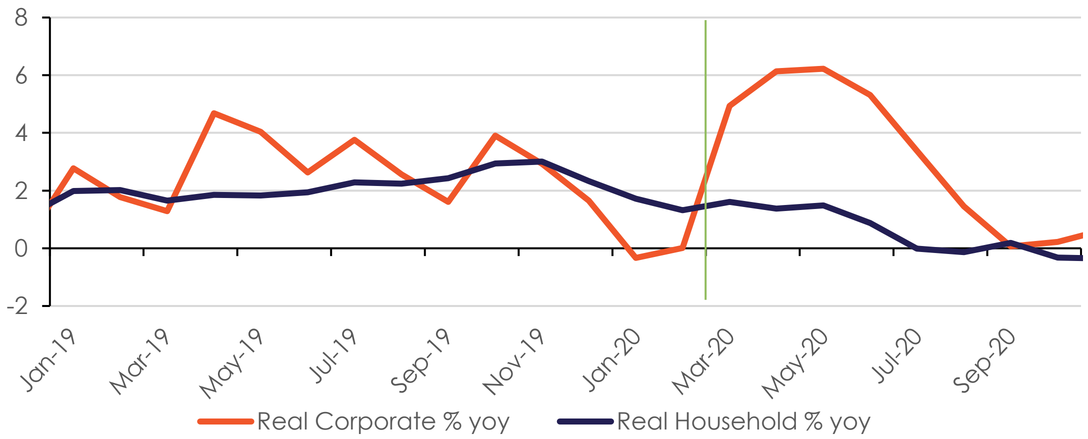
The unattractiveness issues were addressed in part in the July changes to the scheme. These are shown in the tables in section 1. However, anecdotal reports are that banks have continued to require personal surety from borrowers. The considerable uncertainty at the start of the crisis, with businesses uncertain when they could reopen for business, meant business owners had to be risk averse. Few would be willing to put their house and family assets on the line for a loan that may or may not save their businesses. The restrictions on use of proceeds, particularly in not paying dividends, the main form of income for many business owners, further disincentivised take-up. We have heard several anecdotes from businesses who were granted loans but then did not draw them because of the conditions (note that this calls into question the figures on the size of the scheme which are reported in terms of facilities approved, not facilities actually drawn on – the actual amount companies have drawn may be far lower than the R18bn headline figure).

The cost of loans is obviously a driver of demand. At prime, particularly after successive interest rate cuts, the loans are historically cheap. It is evident, however, that the market has not cleared the intended volume of R200bn.

Risk aversion

South Africa has experienced a long deleveraging process since the record levels of household debt of 86.4% of income in 2008, which fell to 71.9% in 2018 before a small uptick to 72.8% in 2019. Private sector credit extension (PCSE) figures show this deleveraging has resumed and, after companies initially drew down on facilities sharply at the start of the crisis, they have since also been deleveraging rapidly (see *Figure 5*).

Figure 5: PSCE growth (in real inflation adjusted terms, % yoy, lockdown marked)



The data indicate that appetite for debt has fallen sharply.

These issues were compounded by the lack of marketing, which should have been undertaken in the context of this being a new government policy push not seen before by SMME borrowers.

The whole conception of the scheme from a political economy perspective, however, was misjudged – to add an unrealistic size "label" that the banks could never conceivably meet, compounded by the fact that they then only signed agreements totalling ZAR67bn.

Small scale of the market

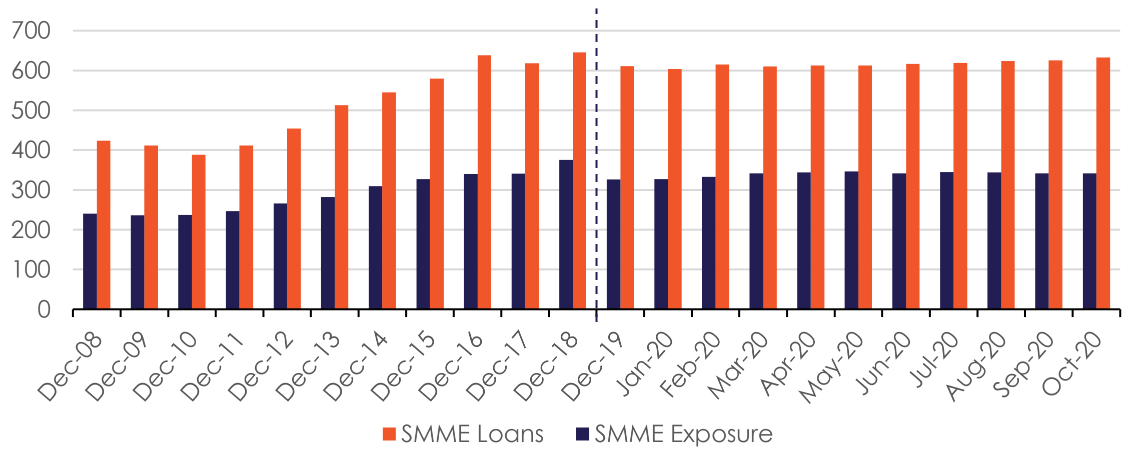
The scheme initially focused on smaller businesses with turnovers below R300m (which are still quite large by most definitions). It also restricted the eligible universe in terms of historic financial position and the degree of Covid-19 impact.

This is a small market that could never have borne ZAR200bn of new debt.

When we look (below) at the outstanding risk exposure (in risk weighted asset terms) and gross loan exposures, we can see that with ZAR611bn of exposure as at December last year of banks to SMMEs,[1] the ZAR200bn is an unrealistic one third of this amount, or two-thirds of risk weighted SMME exposure. The impossibility of a new programme then lending such an amount becomes clear.

It is also interesting from this graph that SMME credit exposures overall have remained flat through the current period despite LGS, thanks to possible underlying deleveraging as well as the impact of the guarantee keeping risk-weighted assets unchanged. Gross loan exposure to SMMEs since the low in April have increased only ZAR19.8bn.

Figure 6: Bank loan exposure to SMMEs and risk weighted credit exposure (ZARbn)



Source: SARB, BA200s

[1] Data is from the BA200s in which SMMEs are defined as businesses with a turnover of under R400m. This is not quite synchronous with the scheme target of R300m, but the point stands as the scheme market size would have been even smaller than that reflected in the BA200s.

Other considerations

We detailed the demand and supply constraints that restricted the scheme in the previous section. We consider the political economy issues here.

Who was responsible?

This is a challenging question but one that needs to be addressed.

As global schemes came together through February and March 2020, NT and BASA could both have started earlier with the design concept phase, which might have saved one or two weeks. The legal process through the second half of April and into May took too long, we think, and should have been expedited. Had it been even a week earlier, demand would have been higher.

It is difficult to comment on the level of connected thinking between NT and SARB. We think there could have been more "joined up" thinking and common purpose towards the end goal.

Where did the ZAR200bn come from?

The banks never committed to the number and only signed agreements totalling ZAR67bn. The amount therefore in reality never existed. We understand it was inserted within the cabinet process to back out of the full ZAR500bn amount. Treasury's reluctance to back to full amount could be seen in the fact it talked about a first tranche of ZAR100bn and then only more "if needed".

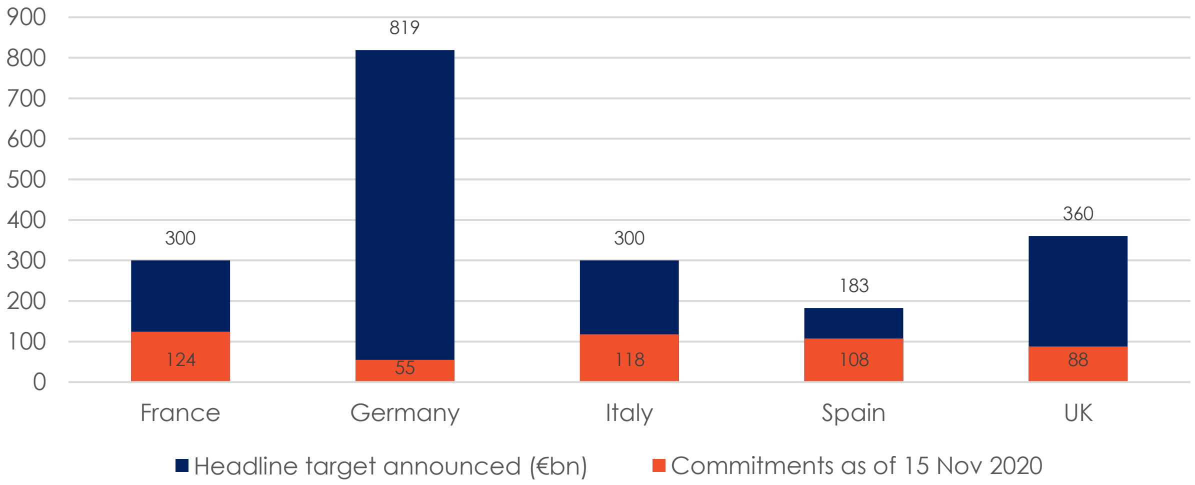
Our initial proposal had put a R200bn tag to the scheme, but we did not restrict it to SMEs. We envisaged a scheme that would accommodate both large companies and SMEs. As a proportion of GDP, it would have been in line with other schemes around the world. Overall, back in March and April 2020 we viewed such a number as appropriate vs more extreme tail risks being contemplated at the time around theoretical constructs of LGS but should not have survived into a plan based on the need for a number that could realistically be hit.

3. International comparison of outcomes and lessons learned from similar schemes

Summary of other schemes

Generally, schemes have fallen short of targets worldwide. South Africa is no exception in this regard.

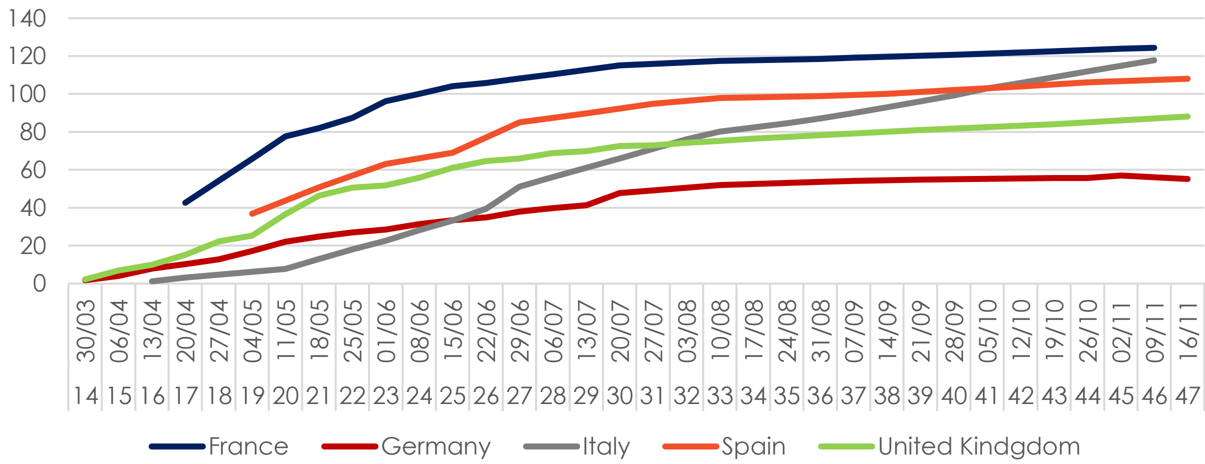
Figure 7: European scheme targets and amounts lent (€bn)



Source: Bruegel Datasets[2]

Also, like South Africa, the rate of growth has tempered over time, despite changes to the terms of schemes.

Figure 8: Government-backed credit support to businesses (€bn)



Source: Bruegel Datasets[2]

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,

[2] Data is available here: https://www.bruegel.org/publications/datasets/loan-guarantees-and-other-national-credit-support-programmes-in-the-wake-of-covid-19/

Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Russia, Slovenia, Spain, Switzerland, Tunisia, Turkey, UAE, United Kingdom, Uruguay. *(We discuss the UK and Brazil in more detail in the Appendix.)*

Generally, the success of schemes is directly related to the degree of risk transferred out of the banking system and onto the national governments' balance sheets. Where changes to schemes have been made they have generally followed a pattern of:

- Increasing the extent of the government guarantee (up to 100% of loans).
- Prescribing banks' credit vetting processes to limit rejection rates.
- Lowering interest rates (in some cases to extended interest-free periods).

Despite cases where loans are 100% guaranteed and banks are forced to accept all applications based on self-declared data from applicants (e.g. the UK Bounce Back loan scheme), borrowing levels have plateaued at levels far short of targets.

4. Options for the future of the LGS

The second wave led to further lockdowns but of a lighter nature with more targeted economic impact. However, give the expected slow pace of vaccination, the likelihood of a third wave from May and possibly a fourth end year the original bridging finance intention of the scheme will become critical again. Preparation should be made now to reinvigorate the scheme as a major source of support for companies that are forced to shut down during a future lockdown.

Waiting

Doing nothing is the simplest option, but the trajectory shows minimal new lending by banks, which won't change. However, further pressure could be placed on banks for commitments to free the existing **backlog of applications**.

Further design tweaks

The tweaks made in July were in the right direction but not sufficient. We outline further tweaks.

Suretyship

There continues to be confusion about suretyship. Banks now have the option of requiring it or not, but in practice all banks seem to still be requiring it. The scheme can be amended to explicitly require that banks do not require it (though this will require a quid pro quo discussed below). Alternatively, suretyship can be limited by, for instance, excluding the primary residence of the business owner (we have seen these approaches in the UK and elsewhere).

Reduce constraints on the use of proceeds

There is no good reason for restricting the use of proceeds. If a business wants to use the lockdown for purposes other than overheads, e.g. to remodel its premises, that is economically positive.

Increase guarantee cover

It is difficult to insist that banks drop suretyship because of the balance sheet buffers banks are providing to the scheme. A quid pro quo is therefore required for the banks to drop suretyship. The only feasible option is to increase the coverage of the guarantee in the scheme. Given the visibility on the credit outlook, this can be done without necessarily increasing risk on the government balance sheet from the levels initially expected at the start of the scheme. There are many international examples of 100% coverage, particularly for small loans. This is not feasible in SA's fiscal position, but the guarantee should at least match the banks' existing expected losses, in the region of 2% per year. This implies 98% coverage, reducing by 200bps per year. This could be achieved by eliminating the 6% bank buffer and relying only on the 200bps margin and 50bps premium buffer, thereafter a 100% guarantee exists.

Set an explicit budget

The public finance aspects of the scheme mean it is difficult for government to signal its risk appetite appropriately. National Treasury has been exceptionally guarded in public about the internal assumptions it has made. 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 an expenditure appropriation is made specifically for any future iteration of the 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.

National Treasury should really be signalling a willingness to lose 6-8% to show that credit risk targeting of support loans are going into a more risk-heavy segment at the margin than your average full loan population which is around 3-4%.

Require commitment from banks upfront

The scheme design committed the SARB to providing R67bn of liquidity but did not impose a volume commitment on banks. Such commitments are difficult but not unprecedented, for example the Financial Sector Charter imposes certain lending commitments on banks. A market share proportional volume commitment could be developed up front. Banks should effectively buy the option upfront while the future is uncertain, rather than have the option of acquiring insurance only once they know how bad things are going to be.

Reducing rates and changing the rates structure

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. 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 well into Q1 2021.

Equity or grant-based schemes

There have been widespread calls for LGS to become a non-repayable grant – on inception and again during the emergency budget period. This would be a very different beast. It would not require banks but would instead be a fiscal transfer. The TERS scheme administered by the Unemployment Insurance Fund has in some ways acted like this, but did not go to business running costs of course (unless furloughed workers are viewed as such). There are much better mechanisms for deploying grant cash to businesses including tax holidays and utility bill rebates as well as schemes such as offsetting rent freezes for commercial landlords – than giving simple cash.

Equity based schemes run into ownership and fiduciary duty issues where the state owns a very large number of very small stakes in SMMEs. Legal costs for shareholder agreements and monitoring costs of such schemes are prohibitive on a widespread basis. This model clearly works for rescue processes of large industries, deploying SA's development finance institutions, but is more challenging for small companies. Such schemes would have to require standardised terms of shareholder agreements which see the entities pay dividends through a collection entity such as the IDC. And they would have to be held in a blind trust at arm's length that saw no state control over management. Certain minimum size requirements of turnover and maximum percentage shareholding are possible which the state would have to put in place. The problem here is not forming some technical framework but its widespread deployment. The challenges that scaling has posed to the SME Fund is instructive here. Support into the private equity industry and pooled vehicles like the SME Fund would be an easier route and are already going on to some degree.

Provincial and municipal based schemes

There is currently a risk aversion within National Treasury about such schemes on a range of fronts including risk, reporting, management and procurement. This is driven by MFMA and PFMA considerations around encumberment. What can be effective, however, are small, targeted, localised fund allocations where banks make smaller commitments and with teams of bankers partnering with a local area. However, the financial strength of municipalities and provinces means that only a small handful would be capable of undertaking such a move. Partners like the SME Fund (which attempted a similar setup with Gauteng in Q3 before it collapsed under regulatory weight) or IDC or private sector SMME-focused entities (including fintechs) could be useful to deploy a standardised template in different localities.

World Bank or IFI/DFI backed schemes

There have been some attempts by banks to look at schemes that draw in external or domestic alternative pools of backstops or guarantees. These could take several forms:

- An IFI like the World Bank takes a pari-passu (equal in ranking) guarantee tranche to allow additional leverage of the scheme and the setting of a larger risk budget.
- An IFI or DFI provides cheaper funding than the bank swap curve at longer terms to allow funding inside prime to occur – particularly where they have highly rated balance sheets.
- IFIs or DFIs take some first-loss tranches to allow the state to invest equity style into entities.

All these are technically interesting but fall into several problems for a joined-up scheme on a pooled basis. The first is that SA's relationship with IFIs is currently strained and the lending constraints of other entities – not to mention this is all quite late in the game – so the interest of such institutions is diminished. Monitoring is also much harder for a pooled programme on a cross-bank basis, which we believe is a deterrent.

This said, the government should be encouraging more bilateral relationships with offshore money pools in unlikely places – such as the recent tie-up between the Dutch DFI pool NASIRA and Sasfin to the tune of EUR35mn in guarantees. Other banks should be attempting similar support mechanisms that are then leveraged into their own product offerings, promoted and publicised. This will be more productive than attempts at mass pooled vehicles.

5. Recommendations

We believe the existing scheme is largely now dead – both considering the stage of the crisis we are in and the purpose of the scheme. It is important to keep in mind that the scheme was intended to be a bridge finance tool, rather than broad stimulus one. Debt stimulus is far better achieved through normal monetary policy that lowers the cost of debt.

However, future covid lockdown waves may provide good reason for it to come back to life, in a new form, as part of a wide package of bank-led support. The tweaks outlined above should be made for that eventuality.

More broadly, however, the scheme's role in the ERRP has to be reconciled with the broader objectives of it.

In that regard, we would reform LGS with the the following recommendations:

a) If the ZAR500bn stimulus commitment stays, then the remaining almost ZAR150bn of unutilised LGS value should be reassigned to recovery loans from banks and DFIs (including DBSA, IDC etc).

b) Government should commit with BASA to joint advertising campaigns to highlight available schemes to support the recovery, done in local language and on radio and in press. This should include a push by banks through email or text messages alerting clients about recovery support.

c) Wider reforms to SMME lending should include an urgent reform effort spearheaded by Operation Vulindlela, with a six-month turnaround timeline committed to. These reforms would include:

    i. Amendments to the NCRA to lower barriers that prevent SMMEs operating from personal bank accounts, particularly in the informal economy especially. Current affordability assessment regulations, in particular, should be amended to accommodate informal businesses and start-ups and to allow for innovative technology enabled credit vetting strategies that are being developed.

    ii. PFMA and MFMA amendments should allow provincial- and municipal-pooled finance vehicles to support their own SMME lending/grant/equity style programmes.

d) Government should encourage and monitor bank pledges to the recovery (aligned with the promotion of financial charter-based commitments) with extraordinary, individual or collective, *voluntary* recovery facilities that each bank promotes individually and collectively through BASA. The promotion of well-designed individual facilities should be seen as more important than rand value amounts, which might lack credibility and banks would be reluctant to make.

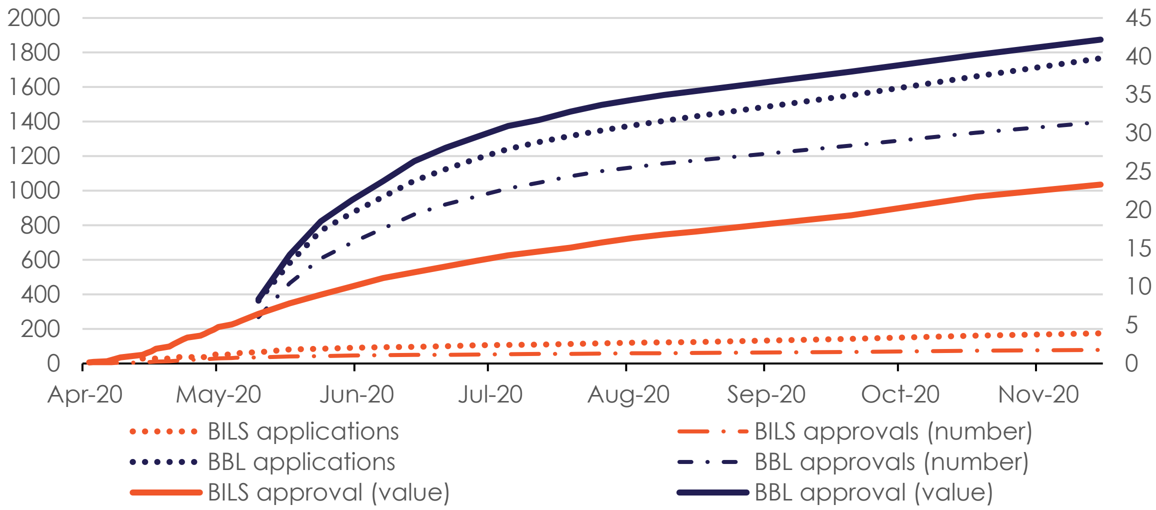
e) Mandate NT to explore additional pools of capital, like NASIRA, that can be match-maked to individual banks on a bilateral basis, through the Jobs Fund or something similar, to support individual bank programmes.

Appendix - Further details on international schemes

United Kingdom

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

UK credit support facilities (volume '000, LHS; and value GBPbn, RHS)



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

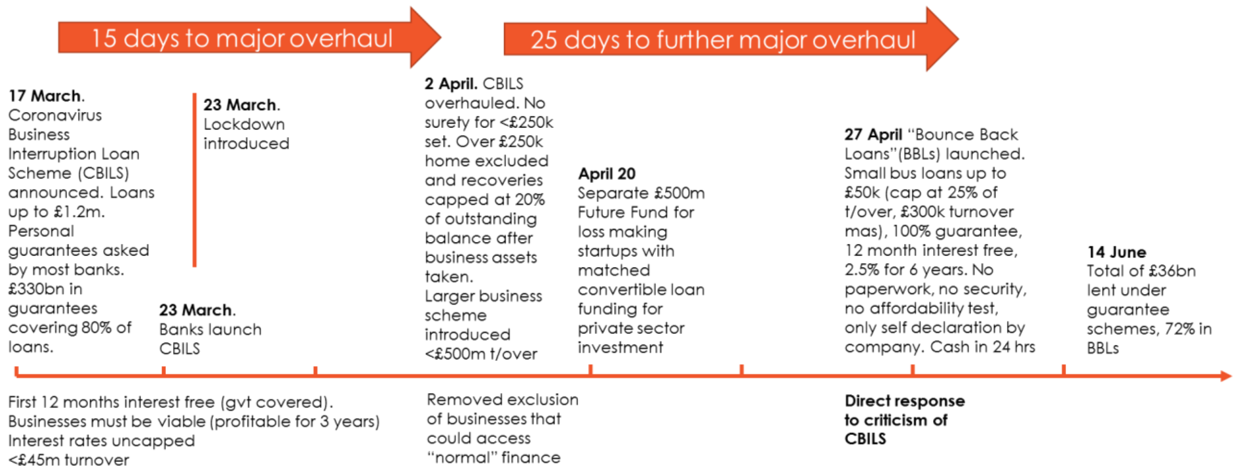
The Coronavirus Business Interruption Loan Scheme (BILS) provides loans to small businesses of up to £5m. Companies must have revenues of less than £45m/year. All loans are made via registered lenders which includes banks as well as some asset-based lenders and smaller specialist lenders (40 in the UK).

Loans are normal term loans, overdrafts, discounting facilities or asset finance. They are interest-free 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 was initially set to run for six months though facilities can be for longer. Banks have committed to a 24-hour turnaround, though in practice this appears to only apply to customers who are already regular borrowers or well known to a bank. The small business schemes are guaranteed by the British Business Bank, a state-owned DFI, which covers 80% of loans. Banks can ask for personal surety from borrowers but large banks have agreed not to for loans under £250,000.

BILS take-up was very slow and led to significant criticism. It was overhauled 15 days after launch, removing the requirement for surety and specifically excluding borrower's homes from the security available. It also capped recoveries at 20% of the outstand balance (i.e. the bank's 20% balance sheet exposure). On 27 April a further scheme was introduced, called the Bounce Back Loan Scheme (BBLS). This allowed loans of £25,000 or 25% of previous year's turnover (whichever was lowest). Applicants merely have to self-declare that turnover and confirm their businesses were affected through an application form. Banks have committed to approving and paying the cash in 24 hours. The scheme is 100% guaranteed by government and banks do not have the discretion to reject applicants who comply with the relevant declarations. This experienced a major spike in loans at first, but even on these liberal terms it tapered quickly, leaving the scheme below target.

Figure 9: Overview of timeline of UK scheme evolution



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, 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 banking sector.

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