TIPS

TRADE & INDUSTRIAL POLICY STRATEGIES

POLICY BRIEF: 5/2020

Covid-19 and small business support: South Africa needs a credit guarantee scheme

OVERVIEW

As South Africa deals with its worst crisis since the start of democracy, the implications and potential fallout for small businesses requires urgent measures that respond to the different needs and requirements of the range of small enterprises.

This policy brief identifies the benefits of implementing a comprehensive credit guarantee scheme that would move the needle in small business support and improve liquidity. Three possible measures that could be used are proposed: a credit card that is guaranteed by the government; a guarantee for trade credit providers; and a credit guarantee for bank SME portfolios. These are by no means the only measures needed, with multiple others required which could include grants, venture capital finance, and improving demand through general stimulus measures.

Trade & Industrial Policy Strategies (TIPS) is a research organisation that facilitates policy development and dialogue across three focus areas: trade and industrial policy, inequality and economic inclusion, and sustainable growth

info@tips.org.za
+27 12 433 9340
www.tips.org.za

Policy Brief by
Saul Levin

INTRODUCTION

Small businesses stand to be hard hit by Covid-19. With limited availability of cash on hand to buffer the typical small business, both the time in lockdown and the immediate period before (with increasing social distance measures), would drain all but the most resilient nonessential services enterprises.

The decline for example in people going to retail and recreational activities was 79% between early March and late March, and a 49% decline in people going to their workplaces over the same period (Google mobility report, 29 March 2020). According to Paul Krugman (New York Times, 7 April 2020), policy interventions by government should be focused on targeting those that lose income as a result of the disaster – with a recommendation to focus on those who become unemployed and providing aid to small businesses as a priority.

The future State of Disaster measures are unclear; however, they will almost certainly see social distance measures continued, and international travel halted for months to come. For those small businesses in the tourism and travel sector, the collapse of international travellers, domestic tourism, business travel and conferencing will be devastating. Similarly, those microenterprises in trade, catering and personal services are equally in jeopardy.

The South African experience of the 2008 Global Financial Crisis was that the post-crisis period had worse outcomes for the country than the crisis itself; with approximately one million jobs being lost – jobs mainly in small, medium and micro enterprises (SMMEs), including the informal sector. Urgent interventions are needed to prevent a similar outcome from the Covid-19 disaster.

While different for different sizes of small businesses, the resources available to small business are typically limited, and a period of low demand, then a shut-down, followed by a prolonged recession is bound to cripple the sector. In the current national and global situation, companies may not be able to borrow at all and implementing a support measure to improve access to finance could be a lifeline for many small businesses while further government measures are implemented establishing effective systems to support the recovery.

Furthermore, support measures need to be considered not only for those businesses that will require funds to continue operations, but equally for new entrants who will be coming into the small business space – either because they have been retrenched and looking for a new form of livelihood, or those who identify new business opportunities in a very different economic landscape that will emerge as a result of the Covid-19 crisis.

The need therefore to ensure that the small business sector is supported has been top of mind for policymakers and philanthropists, with billions in funds contributed to support the sector by the latter. A constrained fiscus has seen

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limited financial resources being allocated to the sector by policymakers. An opportunity exists, however, to implement a meaningful and at scale credit guarantee scheme to create a framework to support the small business sector that would leverage funds of the banking sector, trade credit providers, and global financial reinsurance companies.

Credit guarantee schemes have been used globally by both developed and developing countries to provide a strong counter-cyclical impact, as they prevent a reduction of liquidity, calling up of loans and mitigate the impact of a credit crunch in economic downturns. In the current crisis, part of the global response has been the use of credit guarantee schemes both in dealing with the impact of the crisis and in recovering from the economic impact of the interruption in business activities. It is a recognised instrument and has broad reach.

Historical reasons exist why a credit guarantee has not worked effectively in South Africa. This policy brief proposes that such a measure should be implemented; and should be structured through three targeted and different funds to take into account the different sizes, needs and levels of formality of small enterprises. These include:

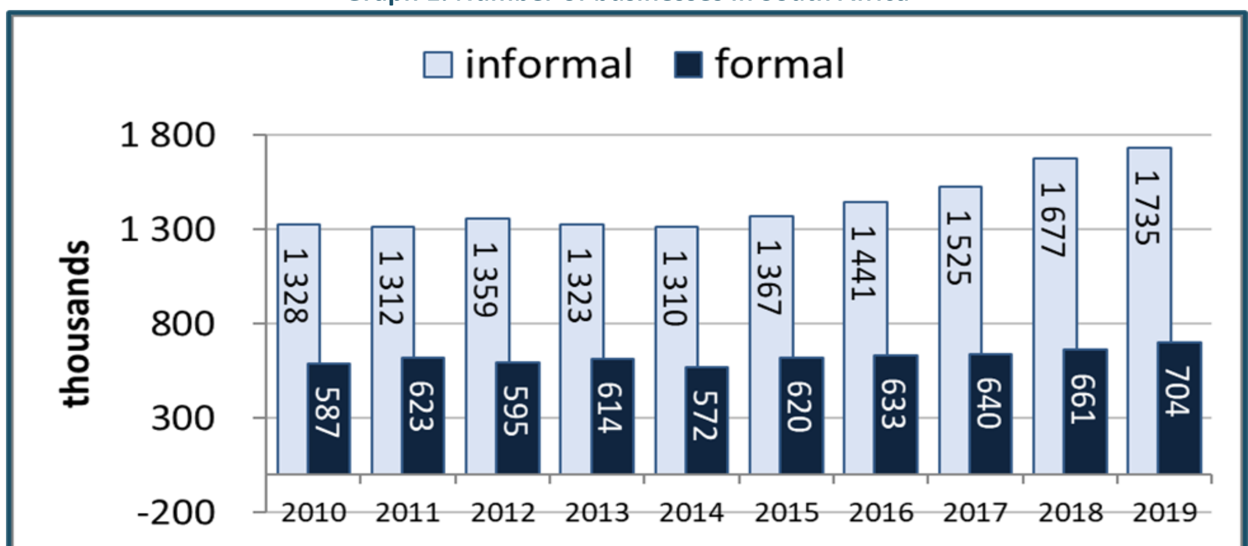
- A fund that guarantees a bank issued credit card to micro and very small businesses with limited credit amounts, to be used for purchasing materials required by traders and value adding small business in light manufacturing, construction, or similar.
- Significantly expanding the current Small Enterprise Finance Agency (SEFA) trade credit guarantee fund, in order to increase the number of wholesalers and materials supply firms that issue credit lines to small businesses.
- Implementing a credit guarantee scheme to guarantee the small business retail loan portfolio of banks to support an increase in credit availability to small businesses, and reduce the risk that there is a decline in finance available to small enterprises during the months ahead, as well as increasing the opportunities for new loan finance to small businesses.

Credit guarantee schemes have the potential, if well-structured, to combine public funding with private credit capacity to achieve a rapid expansion in credit availability to the SME sector using existing credit relationships.

PROFILE OF THE SMALL BUSINESS SECTOR IN SOUTH AFRICA

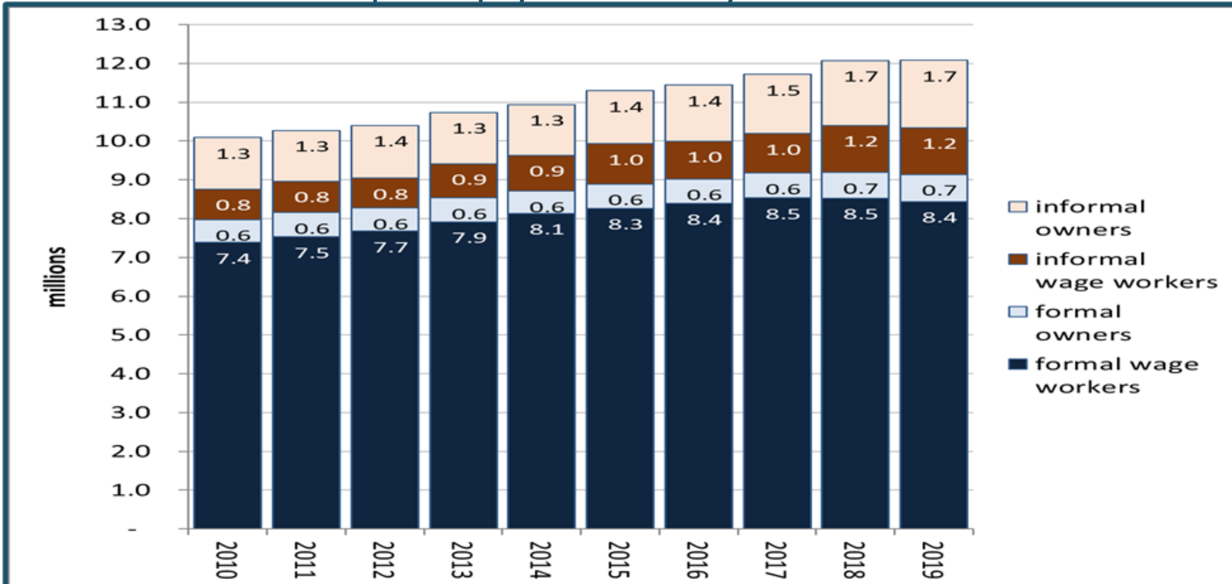
The small business sector, up until end 2019, showed substantial growth in recent years despite the economic slowdown. The graph below shows that the formal sector grew to over 700 000 enterprises and grew by 25% in past four years; with the informal growing to over 1,735 million in 2019, and at 15% over the same period. Despite this growth South Africa stands out as having an unusually small SMME sector, with only 4% of the working age population being self-employed – compared to 15% in other upper-middle income countries.

Graph 1. Number of businesses in South Africa



Source: TIPS 2020, presentation by Neva Makgetla February 2020; data calculated from Statistics South Africa. Labour Market Dynamics Surveys for relevant years. Electronic datasets. Series on sectors including agriculture in formal and informal sectors; employers and own-account workers; and number of employees. Datasets downloaded from Nesstar facility at www.statssa.gov.za.

Graph 2. Employment creation by small business



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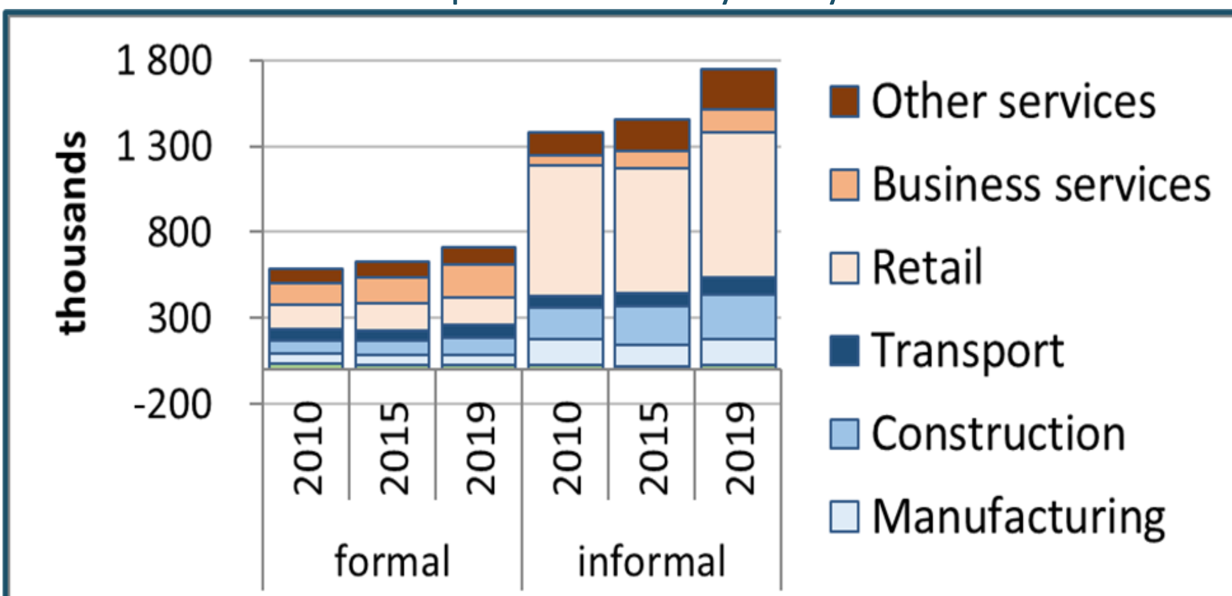
Graph 2 shows that small businesses remain a significant employer in South Africa with 12 million employees (and self-employed) across the sector, out of a total of 16.6 million people employed (SMME figures exclude domestic and family labour). Job creation in formal SMME employment has barely grown since 2015, with the largest growth being in informal self-employed and informal workers.

The total number of formal small businesses are only 40% of the total number of informal enterprises, however they create the bulk of the employment in the small business sector with more than double the number of employees working in formal enterprises compared to the combined self-employed and informal sector employees. Maintaining and growing the formal small business sector is essential for job creation in South Africa.

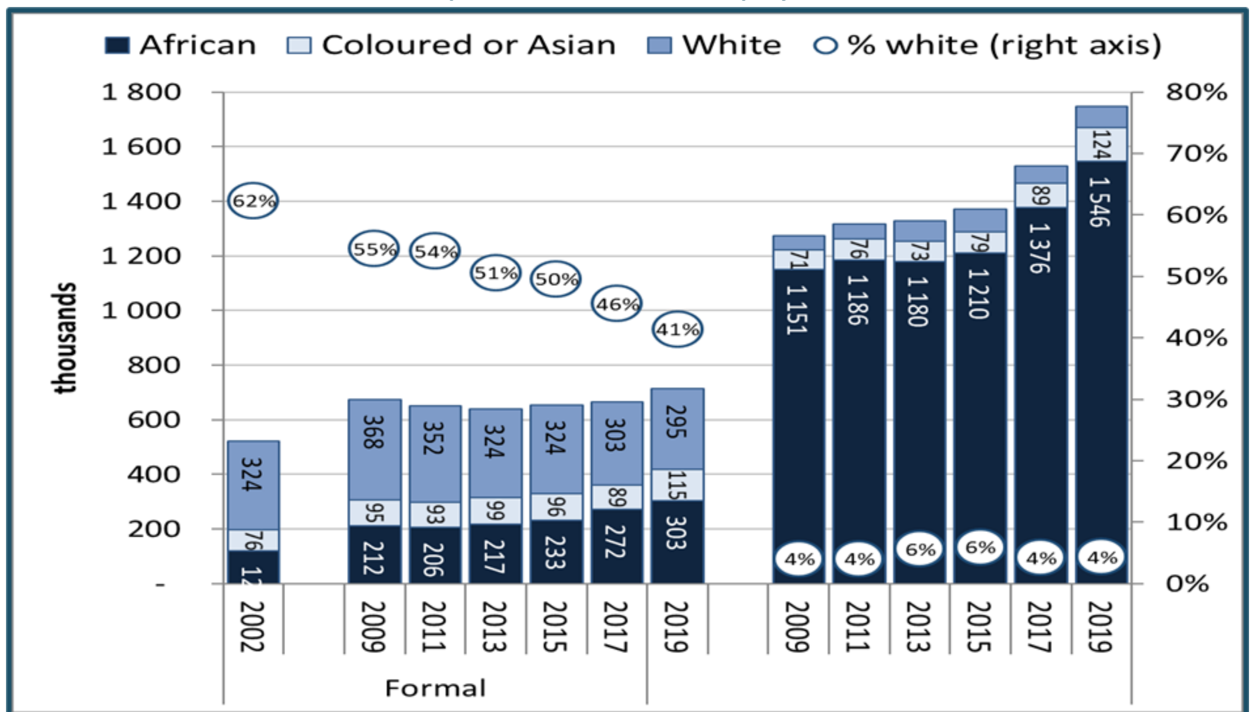
Understanding the breakdown of business by industry provides some insight into targeted support measures. For formal small business, a quarter each are in business services and retail; and a seventh each in construction and other services, while a tenth of formal SMMEs are in manufacturing. For the informal sector, half of small businesses are in retail and under a tenth are in business services. There are, however, still sizable numbers of informal enterprises in manufacturing, construction and other services. A significant number are in transport, which has seen some growth over the past four years. (See Graph 3).

Graph 3. Small business by industry



Source: TIPS 2020, presentation by Neva Makgetla February 2020; data calculated from Statistics South Africa. Labour Market Dynamics Survey. Electronic dataset. Series on sectors including agriculture in formal and informal sectors; employers and own-account workers; and main industry. Datasets downloaded from Nesstar facility at www.statssa.gov.za.

Graph 4. Business ownership by race



Source: TIPS 2020, presentation by Neva Makgetla February 2020; data calculated from Statistics South Africa. Labour Market Dynamics Surveys for relevant years. Electronic datasets. Series on sectors including agriculture in formal and informal sectors; employers and own-account workers; population group; and number of employees. Datasets downloaded from Nesstar facility at www.statssa.gov.za.

In looking at the breakdown of small businesses ownership by race, Graph 4 shows that two fifths of small formal businesses in South Africa are white owned. It is significant that from 2009 there has been a steady increase in black ownership and a decline in white ownership in the formal sector. In 2002 the small business sector had 62% white ownership, and it currently sits at 41%. These demographic shifts are important and alter perceptions of who owns and operates formal small businesses.

WHAT IS A CREDIT GUARANTEE SCHEME?

A credit guarantee is in effect an insurance product that guarantees that a lender of funds will be reimbursed should the borrower default on their loan. A credit guarantee scheme provides the scope for businesses to get access to increased amounts of credit, or to obtain credit without necessarily having the full collateral or credit history usually required by lenders, as it reduces the risk of lending to such enterprises. Such schemes are usually part of a package of support measures to improve access to finance by governments, and part of their approach to small business support.

The impact of implementing a credit guarantee scheme would be to increase lending to existing small business, as well as lending to businesses that would have been previously rejected for finance (or been unable to apply in the first place). Credit guarantee schemes transfer risk from the lender to guarantor, as it mitigates the weaknesses in collateral, and importantly it counters distress valuations in a downturn. Furthermore, it unlocks opportunities for business expansion or new investment by small and medium size enterprises – and job creation; which are important for counter-cyclical responses to economic stagnation.

By drawing increasing numbers of small businesses into the formal financial market, a credit guarantee has a secondary impact of improving information sharing on small business risk and improves participation in credit bureaus, allowing small businesses to build a track record or credit history.

Credit guarantees are a significant measure used in all OECD countries and most developing countries to improve liquidity to the small business sector. Typically, these schemes are run through government agencies that provide the guarantees to the banking sector; increasingly, however, governments are using the new Basel regulations to take the risk off budget and use A-rated global reinsure ance companies.

International examples of countries using credit guarantee schemes include:

- The European Union Credit Guarantee association, which in 2019 had 42 members with €125 billion in guarantees and three million businesses that received cover.
- India: The Credit Guarantee Fund Scheme for Micro and Small Enterprises (CGMSE) in 2016/ 2017 had issued on average 2 000 guarantee a day for an amount of Rs199.49 billion (valued at R42 billion in August 2017).

- Chile: Fogape guaranteed US$1.9 billion between 1980 and 2010, which helped firms receive finance totalling U$3 billion. The fund peaked in 2010 issuing 78 869 guarantees in that year to a total value of Chilean UF41.7 million or US$1.7 billion. The number of guarantees has since declined and in 2014 it issued 48 772 guarantees to a value of US$876 million or R12billion.
- Malaysia: CGC, since its inception in 1972, has implemented 32 different schemes and guaranteed more than 445 000 loans worth approximately US$15 billion. Between 2000 and 2010 alone the CGC backed RM10 billion (R26 billion) in loans.
- Equally, developed countries such as the United Kingdom and United States have credit guarantee schemes. UK has the Capital for Enterprise Limited (CfEL) and the US has the Small Business Administration, which provides loan guarantees among other assistance to small businesses.
- Turkey, Thailand, South Korea, and Taiwan also provide good examples of successful credit guarantee interventions.

The almost universal adoption of Credit Guarantee Schemes has happened because such a measure allows government to expand its reach to many more enterprises by working with the banking sector than through direct lending or only through using state banks or Development Finance Institutions (DFIs). Banks benefit by having cover over their small business portfolio, with reduced losses on SME defaults. The cost of the guarantee or premium paid to a credit guarantee agency is less than the benefit of the guarantee, particularly if capital adequacy requirements are reduced because of the cover over the small business portfolio.

SOUTH AFRICA AND CREDIT GUARANTEES

Lending to small businesses in South Africa has been an issue since the dawn of democracy, and one of the key areas of intervention in the 1995 White Paper on Small Business Development, and the 1996 National Small Business Act. Institutions have been established to provide lending support, among other things. One of the institutions, Khula Enterprise Finance (subsequently changed to SEFA) offered a limited, and undercapitalised credit guarantee scheme.

South Africa through SEFA has a limited credit guarantee fund targeted at small and very small businesses. The guarantee offering started under the former Khula Enterprise Finance, and for reporting and licensing arrangements still retains the name Khula Credit Guarantee. An overview of its performance found declining use of the scheme, which counters the international trends. In 2000 the scheme peaked at providing 650 guarantees (with over R600 million in funds guaranteed) and declined declined from then. By 2012 in rand value the guarantee fund was down to R22 million.

In a 2012 review of the performance of the guarantee fund during the establishment of SEFA the following concerns were identified:

- During the global financial crisis when South African small businesses faced hardship, many closed down and businesses defaulted on their loans, and the fund was then drawn on by the banks. The banks argued the criteria for claiming from Khula were too onerous and thereafter most banks refused to use the facility.
- The guarantee fee of 3% that was charged by the scheme was too high.
- The scheme did not result in banks reducing their risk profile of the businesses for which the guarantee was issued, and as a result did not bring down the price of finance attached to that risk.
- The capitalisation of Khula was limited; and the signal to the banking sector was that a large uptake of the guarantees could not be sustained. The implication is that the banks were wary of "selling" the product to clients because of the ability of the institution to pay if the guarantee was called up.
- The administration of the guarantee was found to be overly burdensome for bank officials, which meant there was no appetite to refer deals to the guarantee fund. The process to obtain the guarantee in the first instance required significant paperwork, and Khula doing its own assessment of the request and application. In the event of a default and claim to obtain the guarantee, it could take up to a year to pay out a claim as the requirement was for a judgment to be issued to the business concerned rather than a letter of demand.

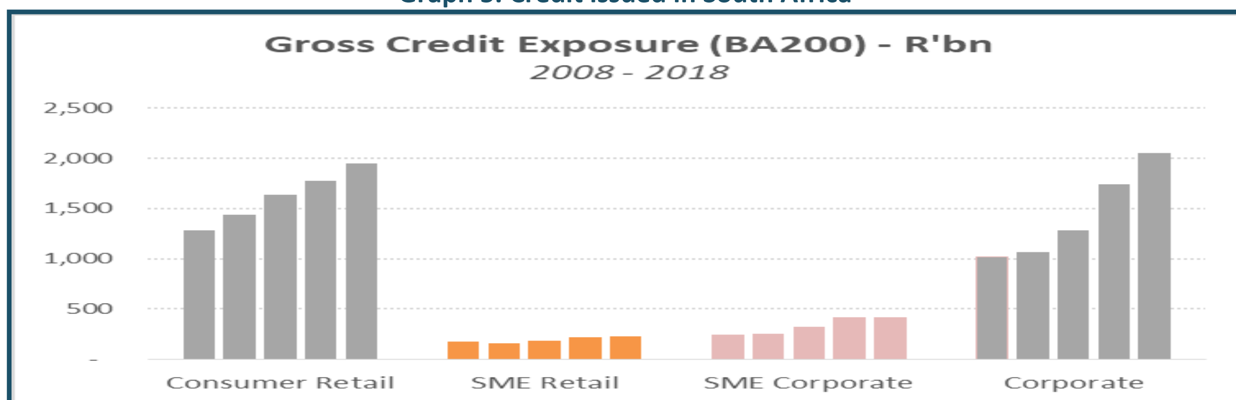
Furthermore, lending by banks to small businesses during and immediately after the financial crisis was severely curtailed due to risk concerns and default.

Following the establishment of SEFA, the credit guarantee programme was resuscitated, and in 2017 R120 million in guarantees was issued. It increased to over R161 million in 2018; and declined to R135 million in 2019.

Over and above the Khula Credit Guarantee, support institutions (such as USAID and donor-funded initiatives) have implemented small-scale credit guarantee funds in South Africa over the years. The Industrial Development Corporation (IDC) also provides a credit guarantee to its clients as part of its package of support (when required).

The current SEFA scheme at R135 million is making an impact but has not been significant enough to "move the needle" in improving access to finance and to act as a counter-cyclical measure.

Graph 5. Credit issued in South Africa



SME retail static, no real growth since 2008/2010 contraction. Very small compared to other credit segments

Source: Gabriel Davel; presented at TIPS Development Dialogue, February 2020; Data from South African Reserve Bank 2019.

Looking at South African bank lending portfolios across market segments shows a significant gap in lending to small businesses in the SME retail category (i.e. loans of under R12.5 million). A total of R228 billion has been lent to this category of enterprises. (See Graph 5).

The aim of a credit guarantee scheme would be to grow the banking sector SME retail loan book.

HOW WOULD IT WORK IN SOUTH AFRCA?

A credit guarantee scheme that is implemented as part of South Africa's response to the Covid-19 crisis would have a significant impact. It would, however, need to address different size enterprises and their different credit needs, or ability to access credit. Using existing institutions would provide the fastest response in the current crisis. The following three measures are proposed:

1. A credit card is guaranteed by the government

Drawing on an approach that has been extensively used by BNDES in Brazil, a partnership with the banking sector is proposed whereby the banks issue a business credit card (that is guaranteed by the state) to survivalist/micro enterprises, a category of enterprises that often are not able to access formal bank credit. The purpose of the credit card to these microenterprises is to support their cash flow and provide a limited amount of credit to buy materials or other goods.

Such a measure would need to consider the following issues in implementation:

- The amounts on the credit card would be small and range between R5 000 and R20 000.
- The credit card facilities are limited such that it can only be used to buy from wholesalers and, for example, cash cannot be drawn or monthly limits imposed.
- In other respects, the credit card works as normal, so once a business repays the card it is able to continue to use it, and over time and a good track record the amount of credit is increased.
- The interest on credit cards are slightly higher than long-term debt but up to a third cheaper than microfinance credit.
- The process allows micro businesses to build a credit profile and graduate to other forms of credit over time.
- Requirements on issuing the credit card would need to be considered so that a balance is obtained between ensuring that genuine traders or microenterprises are assisted with this measure, and the requirements are not too stringent. They would need to develop a process that overcomes the difficulties in ensuring that this measure is able to support informal micro businesses, and not just formal enterprises.
- The requirements for banks claiming on default would need to be streamlined so that claims are processed with minimum requirements (such as a letter of demand being issued) and rapid turn-around times. The lessons from India with three-day turnaround times by the credit guarantee agency on processing claims by banks are useful.

This guarantee scheme could be managed by SEFA or IDC, and if appropriately capitalised, with for example R300 million (which would be leveraged), could see credit going to up to 50 000 microenterprises.

2. Guarantee for trade credit providers

SEFA (through Khula Credit Guarantee) runs a guarantee scheme for trade credit providers. The guarantee is for a portfolio of credit issued by these wholesalers or merchants. It is proposed that this scheme is significantly resourced and capitalised so that the extent and number of trade credit providers is increased to cover materials that include steel, hardware, electrical equipment, construction material, and other types of inputs – e.g. small plastic producers that need polymers.

SEFA already has partnerships in place and a working process. Additional partners would need to be added and the systems used by SEFA strengthened to accommodate a significant increase in trade credit providers.

3. Credit guarantee for bank SME portfolios

To increase lending to the formal SME sector, and grow the SME retail loan book, a viable approach to a credit guarantee scheme is required. It would require a partnership and agreement with the banking sector, who would need to buy into a scheme that would see them paying up to 1% of their loan portfolio as guarantee fees (although likely less based on historical default rates). The financial benefits of the scheme have been calculated to outweigh the cost to the banks, and increase the availability of credit to small businesses.

The benefits to the banks, according to Gabriel Davel, CEO of the Centre for Credit Market Development (see links to presentations in box below), would be: (a) to cover over possible losses on the small business portfolio; (b) the premium payable for a credit guarantee by the banks would be lower than the losses incurred either because the cost of the premium is payable by the small business or because the credit risk is reduced; (c) the balance sheet of the bank is positively impacted as there are reduced provisions for losses; and (d) reduced capital requirements as the portfolio risk is covered by an external party.

The impact of implementing such a scheme would be at least a 10% increase in lending to small business, as banks are able to release capital to increase the amount of finance available to their small business portfolio, as well as take on slightly higher risk.

The following would need to be considered in implementation:

- Implement through the banking sector, and best practice is to do it on a portfolio basis rather than on individual loans.
- Further it would require that the scheme cannot be for only a poor performing loan book, as that would raise the cost of the guarantee cover, as the risk would greater.
- To be of benefit to the banks and society, it would need to be at scale rather than a small ring-fenced portfolio of enterprises.

Click on links to access presentations by Gabriel Davel

Partial credit guarantee schemes and SME lending – February 2020

Facility for credit risk mitigation on SME loan portfolios – November 2019

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- The effective use of technology, with quick turnaround times are essential for the effective management and oversight over the guarantee scheme, as well as to ensure smooth flow of documents for approval and payment processes.
- Unlike the approach taken previously with the Khula Credit Guarantee scheme, the banks are responsible for the lending process, and who and how much they lend; the guarantee fund does not review individual loans given and rather works behind the scenes with the banks that use the product. The control measure is the price of the guarantee, which is based on historical performance of the portfolio.
- The guarantee fund typically takes first loss on loan defaults.
- Banks are required to prove they have taken steps to claim on defaults, that the requirements are not too onerous, and should funds be recovered down the line they would refund the guarantee scheme.
- As there is a risk of "moral hazard" when businesses do not pay because there is a guarantee in place, the specifics of the guarantee are often kept between the bank and guarantee scheme.

Several options exist for an institutional structure to manage a credit guarantee scheme. Further work is required but options could include:

1. The state establishes and capitalises a National Credit Guarantee Agency (which could exist within an existing DFI such as the IDC) to implement the credit guarantee scheme. This is the approach taken historically in other countries. To get to the necessary scale and support by the banking sector it would require capitalisation on the order of R15 billion to R20 billion.
2. The more recent approach being taken by countries is to implement the credit guarantee scheme in partnership with A-rated global reinsurance companies, with local institutional arrangements to co-ordinate the guarantee. This approach limits the capital required to fund a national credit guarantee agency, with some resources set aside to cater for very high risk scenarios such as what we have with Covid-19; this would for example need to be less than R300 million and operates as top up insurance. Options for the institutional structure could be:

- Partnership model with the banking sector like BankservAfrica, where there is joint control and ownership in the implementation.
- Using an existing government DFI such as IDC.
- A new institution such as a National Credit Guarantee Agency.
- A private company is appointed by government to manage the fund.

Given the need to achieve a rapid response to the Covid-19 disaster, option 2 using existing institutions and partnerships would be most desirable.