An Roinn Post, Fiontar agus Nuálaíochta
Department of Jobs, Enterprise and Innovation

Credit Guarantee Bill 2012

Regulatory Impact Analysis

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1 Description of Policy Context and Objectives

1.1 Policy Context

The availability of credit to viable small and medium sized businesses is a recurring challenge that has hampered new or expanding firms from developing new products and markets and thereby protecting or creating jobs. This is a challenge the Irish Government is determined to address. The recently announced plans to restructure and recapitalise the banking system is the principal response to this challenge. These plans are designed to secure an adequate flow of credit into the economy to support economic recovery, even as the banking system is downsized.

Notwithstanding this, there remains an issue that pre-dates the recent banking crisis, whereby new companies or expanding SMEs trying to develop new products or markets struggle to secure finance. This can be due to a lack of familiarity or understanding of the new industry, the new product or the potential of new markets, or the absence of security in the traditional sense.

Under the Programme for Government, a commitment has been given to implement a temporary, partial credit guarantee scheme that will provide a level of insurance to banks against losses on qualifying loans to job-creating firms, designed to get banks back lending again to viable businesses. This commitment parallels a recommendation in the 2009 First Mazars Report on Bank Lending to SMEs for the creation of a loan guarantee scheme similar to those operated in other countries.

Internationally, there are over 2,000 loan guarantee schemes across about 100 countries. Companies operating within and trading from these countries benefit from a range of State supports in accessing capital, in certain cases where risk-sharing is needed to leverage bank lending, including partial loan guarantees and other forms of trade finance. International experience shows such an initiative would involve approximately 2 - 4 percent of total lending to SMEs. However the cohorts of SMEs targeted by this initiative are of strategic importance to national enterprise policy objectives – they are the engines of growth for the future. Therefore, as things stand, Irish SMEs operate at a considerable competitive disadvantage to their competitors across the OECD.

In the last quarter of 2009, the Department of Jobs, Enterprise and Innovation commissioned Forfás and Enterprise Ireland to prepare a paper with a detailed, robust analysis of the operation of loan guarantee schemes elsewhere with a view to identifying best practice and assessing the extent to which a temporary, partial credit scheme could add value to the measures already taken to address the SME credit supply issue and represent value for

money to the State. The Forfas/Enterprise Ireland Report entitled "Small and Medium Enterprise Credit Initiative" was completed in March 2010. This research paper recommends the creation of a carefully targeted SME Credit Initiative on the basis that it would deliver positive returns to the economy and would address the competitive disadvantage being experienced by Irish SMEs.

In July 2010, the Department of Enterprise, Trade and Innovation and the Department of Finance engaged with Forfás and Mr John Trethowan, the Credit Reviewer, to seek to develop options for a loan guarantee scheme which would encourage bank lending to specific categories of SMEs in a way which would not reduce the onus on banks to honour their commitments to increase SME lending, with a view to the early discussion of options at the Cabinet Committee on Economic Renewal.

Following this work, the Government decided to develop a targeted temporary partial credit guarantee scheme as announced in the Jobs Initiative launched on the 10th of May 2011.

This Scheme is designed to support commercially viable SMEs that are at the margins of SME commercial lending decisions because the businesses have insufficient security or the lender does not have the skills to carry out an appropriate assessment of the business proposition.

The Government's commitment will be for an initial period of one year. Specific performance criteria will be set down that allow for review and revision of the scheme at the end of that initial period before any commitment to a roll-over of the scheme for subsequent years. A process of periodic independent lender audits during which samples of lending decisions and default claims would be examined is proposed, which would provide deeper insights into additionality and lender behaviours.

The Scheme will operate under the terms of the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to state aid (de minimis) in the form of guarantees.

1.2 Objective of the proposed legislation

The ultimate objective of this regulatory proposal is to empower the Minister for Jobs, Enterprise and Innovation to establish a targeted Temporary Partial Credit Guarantee Scheme.

The legislation will empower the Minister, to give a loan guarantee, designate a lending institution as a participating lending institution, set eligibility criteria for borrowers in such lending institutions, set loan conditions, set out requirements in respect of liability of the Minister regarding payment of guarantees, to require adequate monitoring arrangements and evaluation, to review and revoke the scheme and to assign a contractor to oversee the operation of the Scheme.

1.3 Objectives of the Scheme

The Scheme provides a Government guarantee to the lender of 75 per cent on eligible individual loans to viable businesses, which is paid to the lender on the unrecovered outstanding balance on a loan in the event of an SME defaulting on the loan repayments. The purpose of the scheme is to encourage additional lending to SMEs, not to substitute for conventional lending. It is not a grant, nor is it support for ailing businesses. The Scheme is intended to address specific market failures that prevent bank lending to some commercially viable businesses by providing a level of guarantee to banks against losses on qualifying loans to job-creating firms. All decision making at the level of the individual loan will be fully devolved to the participating lenders.

Target groups are commercially viable SME businesses, i.e. SME businesses that can demonstrate repayment capacity for the additional credit facilities, but that do not secure credit facilities due to the following two market failures:

1) Insufficient collateral for the additional facilities, or,

2) Growth / expansionary SMEs which due to their sectors, markets or business model are perceived as a higher risk under current credit risk evaluation practices.

This Scheme will facilitate new lending, investment, trade and employment, and will enable SMEs to access sufficient credit to maximise growth potential. A carefully targeted Scheme will deliver positive returns to the economy and will address the competitive disadvantage being experienced by Irish SMEs.

Other Objectives of the Scheme:

- Encourage additional lending to commercially viable SMEs and to reorient lending to the real economy.
- To encourage banks to lend to commercially viable SMEs engaged in new sectors, technologies and markets. In doing so, place Irish SMEs on a more level footing with international competitors that have access to similar schemes.
- To realign commercial bank lending with national enterprise policy objectives.
- To secure the economic benefits from additional lending, through increasing exports, creating/sustaining jobs and facilitating investment in the real economy.

Based on international experience a targeted loan guarantee scheme can support the flow of additional credit, thereby ensuring that these commercially viable businesses are positioned for the economic upturn to deliver the optimal outcome for business and the wider economy - job creation, increased

turnover and value added, higher innovation activity and increased taxation receipts.

1.4 Premium Rate

In return for the guarantee, recipient businesses will be required to pay the Department of Jobs, Enterprise and Innovation (the Guarantor) an annual premium on the outstanding balance of the loan. Premium receipts will be treated as income to the State, and will be offset against the cost of settling Guarantee claims.

The EU State Aid framework sets the requirement that a premium must be charged to the borrower and the minimum pricing of that premium, with the upper limit effectively determined by the maximum borrowers are willing to pay. A premium rate of 2% per annum will be charged, based on the outstanding balance of the loan, assessed and collected annually in advance.

2 Identification and Description of Options

2.1 Do nothing

This option would perpetuate the identified market failures in ensuring a supply of credit to viable SMEs, as identified under section 1.3 above. Furthermore, the Government have agreed that a Temporary Partial Loan Guarantee Scheme be introduced. This was announced as part of the Government's Jobs Initiative on 10th May 2011.

2.2 Introduce a Scheme without Legislation

This option would involve no legislation and instead incorporate requirements of the Scheme into guidance for lending institutions, the borrower and the Operating Body. The Minister has no powers under the Industrial Development Act, or any other Act, to introduce a scheme of this nature, involving the exchequer underwriting part of a loan granted, under strict conditions and criteria, by a participating bank to a third party.

2.3 Stand Alone Legislation

There is an obligation on the part of the Minister to mitigate the risks to the State by making the necessary statutory provision for such a scheme. In addition, any suggestion of a less than rigorous regulatory environment in relation to participation in the Scheme by participating banks or borrowers, could result in moral hazard.

A legislative basis gives the Minister the powers to determine the criteria for participation in the scheme and the power to amend or revoke the scheme,

with the consent of the Ministers for Finance and Public Expenditure and Reform, should he choose to do so.

The proposed Bill also provides safeguards to the State including the capacity to revoke an individual Guarantee and, in extremis, the ability to modify or withdraw the accreditation of a Lender.

In the circumstances, the introduction of a short enabling piece of primary legislation is considered to be the best option.

2.4 Conclusion

A piece of stand-alone legislation is being pursued.

3 Analysis of Costs, Benefits and Impacts

3.1 Costs to the Exchequer

The costs of the scheme arise in relation to the costs on the guarantees paid out (i.e. loans defaulted on) and the cost of operating the scheme. This outflow of funding is partially offset by receipts of premiums paid by borrowers and of any recoveries achieved in respect of loan defaults.

Based on Central Bank SME lending data and the views of the three main banks on the proportion of loan applications they are currently able to respond to positively, as well as the views of SME representative bodies and the UK experience of operating such a scheme, the design consultants have advised that it would appear reasonable to suggest that capacity should be provided to facilitate up to €150 million of additional lending per annum through the Scheme.

The net cost for an annual portfolio of €150 million of guaranteed lending is approximately €6.38 million. To support three years of lending, the lifetime cost to the State is likely to be approx. €19m. This cost is broken down as follows:

Cost of Scheme Administration	€4.00m
Gross Cost of Scheme Claims	€33.75m
Premium Receipts	€18.60m
Net Cost of Scheme	€19.15m
Net Cost per €150m Annual Portfolio	€6.38m
Net Cost per €100m of Lending	€4.26m

The following table itemises the:

- administrative costs;
- cost of settling Guarantee Claims;
- net overall cost after Premium Receipts have been taken into account;

- for three annual portfolios of lending in 2012, 2013 & 2014, each of €150m per annum.

PROGRAMME COSTS

	2012	2013	2014	2015	2016	2017
Administration	0.5m	0.5m	0.5m	0.5m	0.5m	1.5m(*)
Claims						
Gross Claims arising from Year 1 loans	0.0m	6.0m	5.25m	0.0m	0.0m	0.0m
Gross Claims arising from Year 2 loans	0.0m	0.0m	6.0m	5.25m	0.0m	0.0m
Gross Claims arising from Year 3 loans	0.0m	0.0m	0.0m	6.0m	5.25m	0.0m
Claims Totals	**0.0m**	**6.0m**	**11.25m**	**11.25m**	**5.25m**	**0.0m**
Claims + Admin	**0.5m**	**6.5m**	**11.75m**	**11.75m**	**5.75m**	**1.5m**
Premium Receipts	3.0m	5.05m	6.20m	3.20m	1.15m	0.00m
Claims+ Admin Costs less Premium Receipts	**-2.5m**	**1.45m**	**5.55m**	**8.55m**	**4.60m**	**1.5m**

(*) Admin cost for continuing oversight in 2018 & 2019 added into 2017 figure. Requirement for on-going Admin provision will depend upon actual timing of Claims and associated Lender performance.

3.1.1 Cost of Guarantee Claims

Assuming a Scheme facilitating €150m of lending per annum, the resulting cost to the Exchequer after premium receipts but before administration costs will be approximately €5.88 million per €150 million of guaranteed lending.

The proposed three year temporary nature of the scheme caps the costs to the exchequer. The cost of the scheme is a function of four factors –

- the amount of lending covered by the scheme,
  - including a cap on the exposure for each pillar
  - including a cap on the maximum loan to be granted under each pillar

- the level of risk assumed by the guarantor(the State)

- the size of the premium charged to borrowers

- the default rate on the guaranteed loans.

The proposed legislation will provide for all of these to be controlled or capped to limit exposure.

Defaults are more likely to arise in the middle to end of the three year period during which the guarantee applies and this would suggest that default costs would not be significant in 2011 or 2012. By targeting market failure, the scheme seeks to maximise additionality and to limit the impact on the banks' risk profiles and consequential default rates.

Recovery procedures for defaulting loans will be required by participating lenders and defaulting borrowers will be actively pursued. This will have a positive impact on lowering default rates and thus State exposure.

3.1.2 Cost of Administering the Scheme

It is proposed to employ an operator to administer the Scheme. This is estimated to involve an additional annual cost of approximately €0.5 million. The Irish State does not have the existing infrastructure and skills to operate the SME Credit Initiative. While some state entities may have an involvement in certain aspects of the initiative, no existing state entity has the full range of skills, infrastructure and capacity to operate it. Therefore, it has been agreed that the operation of the initiative should be outsourced in order to maximise efficiency, ensure skills capacity and to manage relationships between the State and lenders.

Assuming that the Scheme is open for three years (i.e. supports three distinct annual tranches of guaranteed lending), that for each loan guaranteed the Guarantee is valid for three years (or the term of the loan if shorter) and the maximum lag between a default occurring and a claim against the Guarantee being settled is two years, then a delivery infrastructure will need to be in place for a total of eight years. Assuming that the level of delivery activity will tail off once new Guarantees cease to be issued then lifetime delivery costs are estimated to be €4m.

3.2 Benefits to the Exchequer

The costs identified for the scheme should be seen in the light of the benefits, in terms of GVA, sales, exports and revenue returns, that will be generated by the additional lending attributable to the scheme. International experience has shown that the positive effects of successful projects in terms of GDP, collected taxes, employment and reduced cost of social benefits represent high multiples of the budgetary cost.

This SME temporary partial credit guarantee scheme will facilitate new lending, encourage investment and company growth (scaling), save jobs and facilitate the creation of new jobs, and will boost trade.

The benefits forecast to arise from this intervention in each year of operation, assuming €150 million of additional lending, include:

- Over 1,000 jobs created
- Over €25m of exchequer benefits in tax revenues and welfare cost savings

- 398% return on the State's investment

ECONOMIC IMPACTS & BENEFITS

Quantity/Variable	Value	Assumptions Driving Value
Borrowing Businesses	1,875	Average loan value €76.48k
Defaulted Loans resulting from Failed Businesses	525	
Successful Businesses	1350	
Businesses demonstrating real Additionality	810	
Additional Sales (€m)	81	
GVA (€m)	24.3	GVA 0.329
Additional export sales arising (€m)	21.5-78.2	18
Pillar 1 businesses demonstrating real additionality	648	
Pillar 2 businesses demonstrating real additionality	162	
Pillar 1 direct employment gains	907	2.34 jobs per SME
Pillar 2 direct employment gains	113	2.34 jobs per SME
Total direct employment gains	1020	
Indirect employment gains	324	0.4 per additional business
Total employment gains	1344	
Exchequer Benefits (€m) (Tax revenue receipts and welfare savings)	31.9	€23,741 per employee
Net Cost of Delivery (€m)	6.4	
Net Exchequer Benefit (€m)	25.5	
Return on State Investment (%)	398	Net Benefit/Delivery Cost

3.3 National competitiveness

Loan guarantee schemes have become a pervasive public policy instrument globally. Internationally there are over 2,000 loan guarantee schemes in almost 100 countries. Ireland is one of the few OECD and EU countries that does not have some form of loan guarantee scheme. Therefore, the establishment of such a scheme would place Irish SMEs on a competitive level-footing relative to other trading competitors, who often avail of a loan guarantee in their own country to support trade and investment. International experience indicates that these schemes can support the outflow of additional credit, delivering the optimal outcome for businesses and the wider economy in terms of job creation, and higher innovation activity across knowledge-driven businesses.

The cohorts of SMEs targeted by this initiative are of strategic importance to national enterprise policy objectives. The legislation providing for the Credit Guarantee Scheme therefore would support the realisation of national policy goals, improve the financing environment for SMEs and encourage a banking system that is fit for purpose.

3.4 Industry Costs

Costs arise for industry in terms of the additional annual premium of 2% on the outstanding balance of the loan to be paid by the borrower benefiting from the guarantee to the Guarantor (the State). However, it must be remembered that the borrower would not otherwise have secured the additional credit sought were it not for the guarantee.

Furthermore, it is estimated that all borrowing SMEs which survive to repay their Scheme Facility in full will have experienced an increase in revenues over the term of the Facility of at least 125% of the value of the Facility, i.e. sufficient to service and repay the Facility.

Costs may arise for industry where substitution occurs, that is where companies that would have been funded by banks in any event are brought under the scheme thus increasing their cost of funding. The scheme proposed has been designed to minimise substitution and it is envisaged that the benefits that will accrue from the additionality factor will greatly outweigh the costs of substitution effects.

3.5 Industry Benefits

The Bill will have a positive impact on SMEs as it is a targeted intervention to specifically assist SMEs. It does not extend to large businesses. International experience shows such an initiative would involve approximately 2 - 4 percent of total lending to SMEs.

As stated in paragraph 3.1 above, it is proposed that capacity should be provided to facilitate up to €150 million of additional lending to SMEs per annum through the Scheme.

At this stage an average loan value of €80,000 is assumed, with an estimated 1,875 loans per annum.

The scheme will benefit SMEs by enabling them to access credit that they would not otherwise obtain, for various purposes such as improving cashflow, developing new products and markets, expanding activities, innovation activities and job creation. Cash-flow is recognised as one of the main constraints on growth by smaller businesses.

The Guarantee Scheme will allow a business to not only acquire a loan it could not otherwise obtain, but also to establish a favourable credit history with a lender so that the business may obtain future financing on its own.

Furthermore, it is recognised that the benefits from small business growth accrue more widely than just to the individual company who has accessed the credit through the Guarantee Scheme. There are positive spill over effects into other businesses, activities, and to society as a whole.

3.6 Lending Institutions Costs

Participating Lending Institutions may need to bear the following costs at the outset:

- setting up systems to record qualifying loans and reporting mechanisms,
- “learning” costs, ensuring the right eligibility procedures are in place for the Scheme.

3.7 Lending Institutions Benefits

The Lender benefits from having the State underwrite part of the risk in lending to certain SMEs that would not qualify for credit under the Lending Institutions existing credit policies.

For the Lender the successful performance of the guaranteed lending helps develop experience of and confidence in undertaking that type of lending and provides evidence to inform the refinement of policies in respect of lending in cases of inadequate security or to novel propositions which may otherwise be outside the Lender’s existing risk appetite and parameters.

3.8 Employment

The benefits forecast to arise from this intervention in each year of operation include the creation of over 1,300 jobs.

3.9 North/South

Northern Ireland has a guarantee scheme, which has been in place since the 1980s. The establishment of the proposed Guarantee Scheme would place Irish SMEs on a competitive level-footing relative to their Northern Irish trading competitors, who often avail of a loan guarantee in Northern Ireland to support trade and investment.

3.10 Moral Hazard

The Bill provides for safeguards available to the State including the capacity to revoke an individual Guarantee and, in extremis, the ability to modify or withdraw the accreditation of a Lender.

The Lender must, as far as is reasonably practicable, treat a Borrower with a Scheme loan in exactly the same way as any other comparable customer. The presence of the Guarantee should not make the Lender either more or less rigorous in their relationship with the Borrower. Applicant SMEs must be commercially viable and must support their application for assessment under the scheme with a business plan demonstrating defined and credible growth targets.

The Lender would be entitled to take security in accordance with their normal security policies, including personal guarantees from business owners or others with a beneficial interest in the business.

In respect of the Lender: Devolution of decision-making in respect of individual Guarantees to the Lenders, with that decision-making following the same criteria and rigour as applies to each Lender's comparable commercial lending but with the addition of the Scheme-specific criteria.

In respect of the Borrower: Provision of the Guarantee to the Lender, but with the Premium paid by the Borrower in addition to the normal cost of the loan, meaning that the Guarantee increases rather than reduces the cost of borrowing and it does not affect the Borrower's obligations to the Lender.

In respect of the State: Design of the Scheme ensures that exposure is capped. Delegation of decision-making to the Borrower removes the State from any decision-making at the level of the individual guaranteed loan.

3.11 Deadweight

Deadweight will be minimised by the charging of the Premium (i.e. making it more expensive than conventional borrowing and therefore only something entered into if there is a very definite need for the finance) and by the Guarantee being in favour of the Lender rather than the Borrower (i.e. meaning that there is not a perverse incentive for the Borrower to behave differently in terms of their degree of commitment to successfully repay the loan).

Additionality, expressed in terms of lending taking place which would not have otherwise occurred, will be maximised by training participating Lenders in the scheme criteria at the outset. Specific declarations will be required from the Lenders for each facility guaranteed in terms of loan viability and/or inadequacy of security. Follow-up with appropriate monitoring over the life of the Scheme will ensure that additionality is consistently being monitored and achieved.

3.12 Consumers and Competition

The Scheme is intended to address specific market failures that prevent bank lending to some commercially viable businesses:

1. Insufficient collateral for the additional facilities, or,

2. Growth / expansionary SMEs which due to their sectors, markets or business model are perceived as a higher risk under current credit risk evaluation practices.

At present, the significant majority of all lending to SMEs is managed by AIB and BOI in value and volume terms (€36.5 billion Financial Measures Programme Report). This concentration of lending amongst a small number of lenders reduces competition but also provides an opportunity for the proposed scheme to support the introduction of new SME lenders to the market or the spreading of SME lending amongst a larger group of banks to the benefit of SMEs.

The Bill provides for new entrants to the SME lending market i.e. lenders participating in other guarantee schemes operating in other jurisdictions who are licensed to operate in Ireland but have not traditionally been SME lenders, to apply to the Minister to participate in the Scheme.

3.13 Compliance Burdens

The legislation will add somewhat to the existing compliance burden in lending institutions. However, the compliance burdens on lending institutions with regard to loans having to be registered under the Guarantee Scheme and undergo an inspection regime is not considered onerous when weighed against the benefits of receiving a guarantee from the State.

Every effort will be made to integrate the operation and administration into the existing commercial lending decision and appeals processes to streamline delivery. The design of the Scheme achieves this through devolving decision-making to the participating Lenders and providing each Lender with access to a secure on-line administrative tool for recording and tracking all Scheme-specific information.

Other than the above there are no specific impacts for the following: East West; Gender Balance; Quality Regulation, Social Inclusion, Rights of Citizens, Environment.

4 Consultation

There is broad acknowledgement of the challenges facing SMEs in accessing finance from all stakeholders, and the necessity for Government intervention. This has been underlined by the Mazars' Review of Lending to SMEs, the Credit Supply Clearing Group, the recent establishment of the Credit Review Office and repeated calls from SME representative organisations and individual SMEs for Government action to address the difficulties facing business in accessing credit.

A Steering Group was established and chaired by the Department of Jobs, Enterprise and Innovation, with representatives from the Department of Finance, the Central Bank, Forfás and Enterprise Ireland.

Members of the Steering Group have held detailed consultations with interested parties (e.g. business representative organisations, banks, Irish Banking Federation, the European Commission, the Department of Finance, the Department of Public Expenditure and Reform, the Credit Review Office, the Central Bank, the Office of the Attorney General and other relevant Departments since April 2011.

The organisation charged with the design of the Scheme, Capital for Enterprise Ltd. also consulted with various interests in September 2011 as follows:
Bank of Ireland, Ulster Bank, AIB, Irish Banking Federation, Central Bank, Credit Review Group, Enterprise Ireland, ISME, Chambers Ireland, Irish Hotels Federation, Irish exporters Association, Small Firms Association and IBEC.

All of the views raised from the various parties were taken into consideration in the design of the Credit Guarantee Scheme.

5 Enforcement and Compliance

The enforcement and compliance aspects of a credit guarantee scheme are critical to managing the exposure of the State. The Bill provides for the Scheme design to make provision in relation to all matters pertaining to enforcement and compliance.
The Bill provides for the conditions that must be satisfied in respect of a loan.
The Bill also provides for the following:

- Eligibility criteria for borrowers
- Eligibility criteria for lenders
- Power to appoint operator to administer the Scheme
- the power to amend or revoke the scheme.

The proposed Bill also provides safeguards to the State including the capacity to revoke an individual Guarantee and, in extremis, the ability to modify or withdraw the accreditation of a Lender.

It is proposed that the operator would be contractually responsible to the Department of Jobs, Enterprise and Innovation for undertaking Reporting/Monitoring/Auditing/Evaluation functions and that this would form part of the specification of the operator's role.
Furthermore, the legislation will provide for the operator to be subject to audit by the C&AG.

6 Review

The proposed Bill provides for regular and significant oversight and review of the scheme. For any Scheme of this type to be successful there is a need for the Department and lenders to have regular access to data on scheme-related performance and behaviours, and for a regular interpretation of that data and appropriate consideration of the implications of those findings. The operator will be responsible for this data-gathering, analysis and reporting process.

The operator will provide the Department with quarterly reports and analysis on the performance of the Scheme.

The Government's commitment will be for an initial period of one year. Specific performance criteria will be set down that allow for review and revision of the scheme at the end of that initial period before any commitment to a roll-over of the scheme for subsequent years. A process of periodic independent lender audits during which samples of lending decisions and default claims would be examined is proposed, which would provide deeper insights into additionality and lender behaviours.

The legislation will be kept under review and will be updated as needed.

Furthermore the operator will be required to keep the Minister informed of the impact of the new legislation and both their experience and the experience of the lending institutions regarding operating the new regulatory regime.

ENDS