WORLD BANK GROUP
Finance, Competitiveness & Innovation

Public Credit Guarantees in the Time of Covid-19

Pietro Calice

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Outline

1. Are PCGSs the right policy tool to address firms' liquidity needs during the Covid-19 crisis?

2. How should PCGSs be designed during the Covid-19 crisis?

3. Concluding remarks

Are PCGSs the right policy tool?

- The Covid-19 crisis has led to a liquidity shock that, *ceteris paribus*, should not compromise firms' solvency on a large scale.
- Monetary and prudential measures have aimed at creating space in banks' balance sheets yet they will only be effective if banks are able and willing to lend.
- Given the high credit risk, banks can provide lending to the real economy only in the presence of public backstops hence well-designed PCGSs can provide the right incentivizes.
- As of May, PCGSs mobilized in the context of the Covid-19 crisis amounted to about US$ 1.8 trillion or 2% of global GDP.

Institutional framework

- PCCGs should ideally be administered by independent legal entities or by existing development finance institutions running earmarked programs.
- It would be advisable to use PCGSs in the context of the Covid-19 crisis only if an existing credible institution or program is already in place that can be easily scaled up and adapted.
- Should a PCGS not exist, the government could create a guarantee fund or a trust and outsource its management to a private company based on clear operational parameters.

Funding

- Sufficient paid-in capital should be available to ensure an effective launching of the PCGS and its subsequent viability (unfunded schemes not desirable).
- Covid-related PCGSs should ideally be funded with fresh and earmarked resources yet the current circumstances may provide for a waiver to this general principle — in that case ensure proper accounting.
- Optimal size of the PCGS is complicated — function of fiscal space, target groups, risk distribution and leverage.
- Multilateral and bilateral funding in the form of capital, counter-guarantees and co-guarantees, could contribute to leverage government resources and experiment with a tiered structure of loss sharing to maximize impact.

Prudential regulation

- PCGSs are typically regulated and supervised by the financial authorities and subject to minimum prudential requirements — these rules should not be relaxed.
- The public guarantee should be designed to provide capital relief to the lender — favorable treatment of exposures to the government — and favorable provisioning.
- Problematic in the context of consolidated exposures of banking groups when the home authorities of internationally active banks do not recognize the preferential treatment applied by host authority for subsidiaries — material where foreign banks are dominant.

Leverage

- One of the main arguments in favor of using guarantees as opposed to direct forms of intervention.
- Double-edged sword: high leverage can theoretically both contribute to a PCGS’ sustainability and threaten its solvency.
- A maximum level of leverage should be specified that in the context of the Covid-19 would reflect the higher than normal expected default rates — range of 4-6 times should be appropriate in many jurisdictions.
- The multiplying effect of a PCGS and its capacity can be boosted by a partial counter-guarantee provided by highly rated multilateral or bilateral organizations.

Delivery modalities

- Individual vs. portfolio approach involves a tradeoff between efficiency, quantity and quality.
- In the context of the Covid-19 crisis, where firms' survival is more important than true economic additionality and speed is of the essence, a portfolio approach would be the preferable option.
- A hybrid approach could also be adopted, where for example loans up to a certain amount may qualify for portfolio guarantees, whereas large loans are assessed by the PCGS on a case-by-case basis.
- It would be important to streamline and clarify upfront the application process to speed up implementation.

Coverage ratio

- PCGSs should require banks to keep “skin in the game”, thus both protecting the solvency of the public sector and leveraging lenders’ ability to discriminate between good and bad credit.
- Optimal level to depend on the riskiness of the underlying loan portfolio and the size of the PCGS to ensure its sustainability.
- In the Covid-19 crisis credit risk is higher than in normal times and likely more than in other crisis times hence higher than usual coverage ratios can increase banks’ willingness to participate in the scheme.
- Coverage ratios of 80%-90% depending on the target groups should be appropriate in the current environment.

PCGSs are not panacea

- A critical constraint is the fiscal space available to the authorities to size a scheme capable of making the difference without undermining the solvency of the public sector.
- The existent legal and market infrastructure, banks' capital and liquidity resources, and the degree of uncertainty about the shock and the economic outlook are all elements that will inevitably hinge on the effectiveness of a PCGS.
- There is no blueprint for the design of a PCGS in the time of the Covid-19 crisis yet it is essential that PCGSs are part of an integrated and comprehensive policy response that combine transparency, effective market discipline and preservation of financial intermediation capacity.