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Assessing South Africa's Loan Guarantee Scheme to support firms during the Covid-19 Pandemic

by

Vuyisiwe Mahafu and Kenneth Creamer

Abstract

This article presents a timeline and data on South Africa's Loan Guarantee Scheme (LGS) established in response to the Covid-19 pandemic. It defines the LGS take-up rate as a key measure of the effectiveness of the policy's design and implementation. It references relevant theoretical literature, on co-ordination theory, incentive structures, information asymmetries and market failures, to provide explanations for the low take-up rate of South Africa's LGS. It presents comparative data on the take-up rates and design features of LGS-type interventions in a number of other countries. Finally, the article draws lessons from South Africa's LGS experience which would be relevant for planners and policy makers implementing similar such policies in future.

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1. Introduction

In response to the Covid-19 Pandemic and the resultant public-health-driven lock-down, the South Africa government during the course of 2020 and 2021 implemented a number of interventions to support firms and employees negatively affected by the Covid-induced economic shock. One such intervention was the Covid-19 Loan Guarantee Scheme (LGS)[1] put in place initially to support Small and Medium-Sized Enterprises (SMEs) and was then expanded to also include larger enterprises.

The objective of this article is to resolve the puzzle - why did South Africa's Covid-19 LGS have a relatively low take-up rate as compared to similar credit support schemes adopted in a number of other countries? In order to answer this question, the article uses comparative data and relevant economic theory in order to identify which aspects of South Africa's LGS's design contributed to the relatively low take-up rate of the support measure. Based on this analysis, the article draws policy lessons for the design of similar interventions in future.

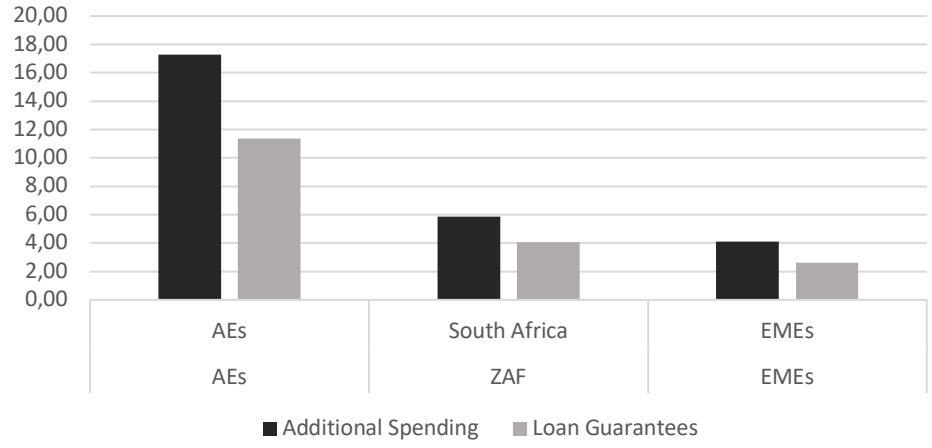
The article, firstly, presents a timeline and relevant data on South Africa's LGS relating the scheme's low take-up rate to specific design and implementation factors, secondly, discusses the low take-up rate of South Africa's LGS with reference to relevant theoretical literature on LGS-type interventions including literature on incentive structures, co-ordination theory and correction for market failures, thirdly, reflects on the take-up rate and design and of similar LGS-type interventions in a number of other countries, and, fourthly, presents findings and draws policy-relevant lessons from the aforesaid analysis of the South African LGS experience, before concluding.

[1] A guaranteed loan is one in which a third party guarantees to settle the loan in the event that the borrower defaults. The aim of an LGS is to enable otherwise excluded borrowers to qualify for loans and to give lenders an assurance that their risks have to a large degree been mitigated. In the South African case, the Covid-19 LGS was created with the objective of supporting firms to help them to cope with the negative economic effects of the Covid-19 pandemic.

2. Timeline and data on the implementation of an LGS in South Africa in response to the Covid pandemic

The overall quantum of South Africa's firm-support response to the Covid-19 pandemic was comparable to interventions undertaken in other countries. As indicated in Figure 1, IMF data shows that, in response to the COVID pandemic, South Africa spent the equivalent of 5.9% of the country's GDP on 'additional spending or foregone revenues' and 4.1% on liquidity support, such as, the LGS, this was above the average for such measures for emerging economies (EMEs), of around 4.1% and 2.6% of GDP on additional spending and LGS-type interventions respectively, and below the global average for advanced economies (AEs), of around 17.31% and 11.4% of GDP on additional spending and liquidity support respectively (International Monetary Fund 2021).

Figure 1. Comparative Additional Spending and Loan Guarantees (as % of GDP)



In South Africa, firm-level support in response to the Covid crisis included the deferment of firms' regular tax payments for a number of months, and a highly effective Temporary Employee-Employer Relief Scheme (TERS) which mobilised Unemployment Insurance Funds (UIF) to assist in funding salary payments for those in formal employment. In addition to these measures, South Africa implemented an LGS with the objective of providing liquidity to South African firms impacted by the crisis. The timeline for South Africa's implementation of the LGS is recorded in Table 1.

Table 1 Timeline for implementation of LGS in South Africa in response to Covid

Date	Activity
23 March 2020	South African President Cyril Ramaphosa addressed the nation and announced that, due the public health crisis resulting from the global COVID pandemic, South Africa would pursue a lockdown policy from 26 March 2023.
20 April 2020	President Ramaphosa introduced the Loan Guarantee Scheme as a crucial component of the economic stimulus package aimed at supporting SMEs.
4 May 2020	The National Treasury, the South African Reserve Bank, and the Banking Association South Africa collaboratively finalised the detailed design, legal agreements, and administrative processes required for the implementation of the loan guarantee scheme. Through this process R100-bn is made available to the LGS with the option to increase the value of the measure if necessary.
Starting 11 May 2020	Participating banks began receiving and processing applications for Covid-19 relief loans.
July 2020	Several stringent eligibility requirements for borrowers were relaxed, resulting in an increase in loan uptake
15 August 2020	The total amount disbursed in terms of the LGS had risen from R2.2 billion in June 2020 to R13.3 billion.
From August 2020 to March 2021	Total loans issues increased to R18.16 billion.
April 2021	The deadline for loan applications was extended by three months, pushing it to 11 July 2021. This extension was implemented to harmonize the deadline for all participating banks.
End of June 2021	The total loan uptake of the LGS had reached R18.4 billion

The South African Reserve Bank (SARB), the National Treasury, and South Africa's commercial banks were the three key participants in the LGS. The SARB provided funding to commercial banks for the loans and kept track of how much each bank owed, as well as default rates. The National Treasury guaranteed part of the loans made by nine participating commercial banks.[2]

The take-up rate of the LGS is a key metric in assessing the success or failure of the intervention. The take-up rate is defined as the extent to which beneficiary firms utilise (or take-up) the envelope of fiscal resources allocated towards the LGS support measure, that is, the ratio of the value of grants allocated to beneficiary firms to the overall amount of fiscal resources allocated to the scheme. In the case of the South

[2] The participating commercial banks were Absa, Bidvest Bank, First National Bank (FirstRand), Grindrod Bank, Investec, Mercantile Bank, Nedbank, Sasfin Bank and Standard Bank.

African LGS in response to Covid, R100-bn was allocated by the National Treasury as a guarantee for the scheme in May 2020, and by the end of June 2021 the total loan uptake by beneficiary firms was R18,4-bn. As such the take-up rate of South Africa's LGS was around 18,4%.

This relatively-low take-up rate was a function of how much fiscal support was allocated by government to the LGS, as well as how many firms applied for access to the support measure, and how many firms were finally granted access to the support measure. All else being equal, for a given fiscal allocation, a relatively high take-up rate would be indicative of effective policy design, administrative efficiency and appropriate incentive structures for the scheme's participants and beneficiaries. On the other hand, a relatively low take-up rate would be indicative of flaws in the design of the LGS policy and other related inefficiencies.

The program was supposed to run from April 2020 to April 2021, however it was extended to July 2021 due to the lower take-up rate than expected. In an effort to improve the take-up rate, the original design was updated in July 2020 with the aim of improving the take-up rate.

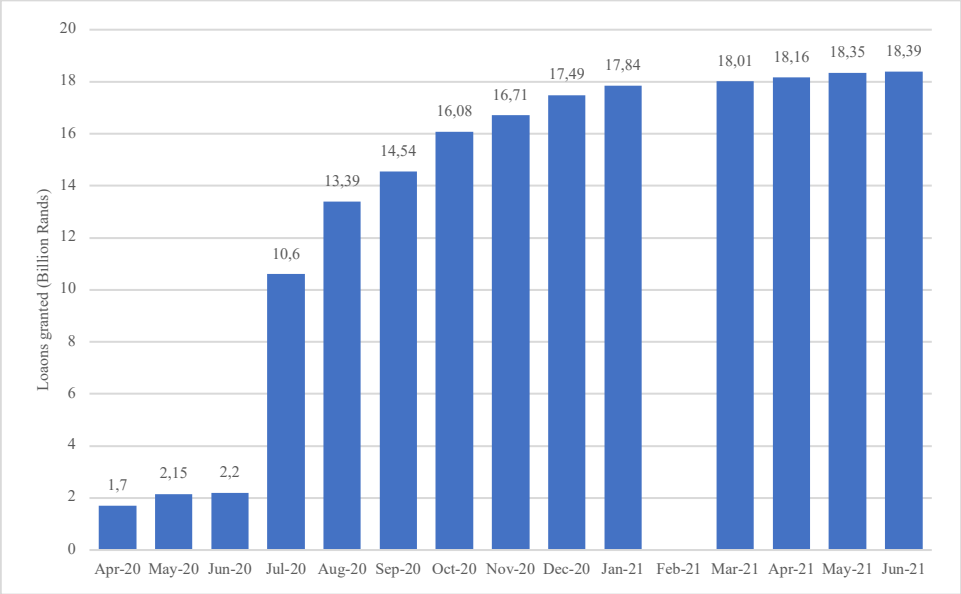
Iterative changes to the design of the scheme included the following – instead of limiting the scheme to companies with an annual turnover of under R300m, companies with any size of turnover came to be eligible after July 2020. Furthermore, with the updated design, owners' 'salary-like' drawings could be funded by the scheme, whereas previously only rental, salaries, debt service costs and other fixed costs could be covered. Additionally, loans would have to be repaid over six months after a six month payment holiday, rather than over three months after a three month payment holiday.

As can be seen from Figure 2, the take-up rate of the scheme improved after the implementation of the design improvements in July 2020, increasing from a cumulative R2.2-bn take-up to a cumulative R10.6-bn take-up from June 2020 to July 2020. However, overall, the scheme was not as effective as originally envisaged, with a total

take-up rate of only R18,39-bn (around 18.4%) of the original R100 billion that had been allocated to the mechanism.[3]

Overall, the LGS received nearly 50 000 applications, of which 26% or about 13 000 were approved and taken up. Of the all loans approved and taken up, about 82% or 10 660, went to small enterprises with a turnover of less than R20 million, constituting a total loan value of R6,77-bn (about 37% of the value of all loans dispersed).

Figure 2: Covid-19 LGS cumulative uptake – South Africa



(Source: Banking Association of South Africa, 2021)

It was mainly companies with a turnover of between R1 million and R20 million that made use of the LGS, with such companies accounting for 72% of the total loans approved. Companies with a turnover of less than R1 million accounting for 10% of loans approved, and companies with a turnover of between R20 million and R50 million also accounting for 10% of loans approved.

According to the Banking Association of South Africa (2021), the main reasons for rejection was due to the fact that applying companies were not in good standing (35%),

[3] Only national data is presented and is drawn from an interview with a representative of the South African Reserve Bank, as well as available government and banking sources (such as that complied by the Centre for Excellence in Financial Services 2023). Other than data disaggregated on the basis of company size, proxied by size of annual turnover, no data was found to be available based on such other factors as race or gender of the applicants, or provincial or other geographic breakdown.

followed by loan value requested too high (29%) and by the fact that the application was not based on a Covid-19 matter (20%).

One of the key reasons for the LGS's low take-up rate may have been that some of the LGS requirements disincentivised firms from taking up the loans. In interviewing those involved in setting-up he LGS it was established that while collateral from firm owners was not mandatory as part of the original design of the LGS, banks were given the discretion to impose such requirements (Naidoo, 2021). To protect their interests, commercial banks required customers to take a certain amount of risk in their personal capacity.

Another structural problem was that the scheme became available about seven weeks after the Covid lockdown started. By that time many distressed companies had accessed forbearance measures with commercial banks or had made other plans to manage their financial positions.[4]

Firm-level survey's conducted by the Centre for Financial Excellence (2023) confirmed some of these limitations on the LGS, finding that "demand for the scheme was curtailed by the fact that qualifying business owners were reluctant to take on more debt in a weak and uncertain business environment, and some had already made financial relief arrangements directly with their own banks."

3. Discussion on South Africa's LGS with reference to relevant theoretical literature

The aim of South Africa's Covid-19 LGS was to support firms by facilitating access to credit for business entities that may not have had the collateral or credit history that would normally be required in order to access such credit. The essence of the scheme was that, given the extra-ordinary circumstances of the pandemic, public money

[4] A structural feature of the LGS, although not one that would impact directly on firm incentives, was that due to the fact that the SARB is not legally-entitled to take on risk, the National Treasury was required to underwrite any losses. Yet, the Treasury never put a specific number on how much it was budgeting for such potential losses. According to the analysis done by Theobald *et al*., (2021), to cushion unexpected losses, the National Treasury set aside a contingent obligation, rather than a fixed budgeted sum.

should be made available as a guarantee to commercial banks that they would receive government assistance if businesses defaulted on their payment obligations.

It is significant that in the South African case a potential co-ordination problem, typically associated with LGS interventions, was overcome through government-led action to establish such a credit support scheme as part of its overall response to the economic challenges associated with the Covid pandemic. Such coordinated LGS interventions are advantageous in a banking sector with asymmetric knowledge, as instead of a single bank making loans for SMEs, interventions prove to be more effective through the operations of a mutually cooperative banking network (Green, 2003). This cooperative banking network was further supported in the South African case by the authorities taking a leadership role in LGS policy-making backed by the security of government guarantees.

Such coordination by the South African Reserve Bank (SARB), private Banks and National Treasury was necessary given the legal and regulatory stipulations governing the banking sector. The South African Reserve Bank Act of 1989 prohibits the SARB from making unsecured loans, thus the National Treasury was required to provide collateral. Commercial banks were lent money by the SARB at the repo rate, which was 3.50 percent, plus a 0.5 percent credit premium. The money was then lent-on to SMEs by commercial banks at the repo rate plus a predetermined spread of 3.5 percent (National Treasury, 2020).

A key objective of South Africa's LGS was to provide firms with funding to continue paying for operational costs, such as, salaries, rental costs, and supplier costs. The aim was to ensure that firms were offered temporary support through the pandemic so that job losses would be limited, and firm recovery made easier, with the overall policy objective of limiting the depth, duration, and economic impact of the crisis.

In general, the theoretical support for South Africa's LGS was informed by the fact that such credit support schemes aim to increase access to finance by eliminating the problems caused by information asymmetries and market imperfections which are at times exacerbated by economic shocks. According to Adhikary et al, via LGS-type interventions, financial institutions evaluate loans and give credit guarantees to qualifying businesses, such as those with strong prospects but limited access to bank loans. LGS assist banks in reducing their lending risk, which typically results from

information asymmetries, and assist banks in unlocking funds for specific sectors, such as SMEs, leading to a rise in non-guaranteed loans (Adhikary, Kutsuna, & Stephannie, 2019).

The aim of LGSs is to encourage commercial banks to lend to SMEs that have viable initiatives and a good chance of success, but lack adequate collateral or a sufficient record of financial transactions to demonstrate creditworthiness (Levitsky & Prasad, Credit Guarantee Schemes for Small and Medium Enterprises, 1987). LGSs also allow lenders to transfer some loan recovery risk to the guarantee program, attempting to overcome credit conditions and credit limitations faced by SMEs (Robert & Dale, 1997).

Policy actions can strengthen bank lending in the event of a substantial, but temporary, shock using two complementary strategies. Firstly, they can increase the lending capability of banks by improving their capital and liquidity levels. Secondly, they can motivate banks to use this capacity by improving the risk-return trade-off for extending additional loans (Casanova *et al.,* 2021).

According to (D'Ignazio & Menon, 2013), the empirical evidence on the effectiveness and effects of credit guarantee programs is inconsistent and in certain instances the schemes have had no effect on the total amount of bank debt held by firms. A key reason for these mixed results is due to specific design details of various LGS mechanisms and their related incentive structures. This emphasis on appropriate incentive structures is reinforced by the South African case where a relatively low take-up rate for South Africa's LGS was associated with negative incentive structures, such as, the requirement for collateral to be provided by borrowing firms, as well minor delays in making the LGS available to firms who in the interim may have opted for alternative funding mechanisms, such as provided directly by the commercial banks.

Two aspects of the incentive structure that appear not to have been overcome by the design of South Africa's LGS are adverse selection and moral hazard, both of which originate from the kind of information asymmetries which ultimately impact negatively on the availability of loans to firms, leading to credit rationing (Stiglitz and Weiss, 1981). Credit rationing becomes a feature among loan applicants who appear to be identical, but where some are granted credit while others are denied access to credit.

In the South African LGS case only 26% of applications were ultimately approved exacerbating the low take-up rate.

An additional factor identified as important in the literature, but which, due to the relatively low take-up rate, could not be properly tested in the South African context is the matter of how best to measure the broader economic impact of credit support schemes. According to Winckler et al (2021), the success or failure of an LGS scheme implementation is not solely determined by the quantity and the value of guarantees issued, but more by its capacity to make advances the following two critical dimensions: financial additionality and economic additionality. Financial additionality measures the amount of lending that would not have occurred but for the LGS guarantees. Economic additionality measures the enhancement of firms' competitiveness and expansion into new economic activities. The authors argue that it is only when the LGS scheme achieves these objectives, while at the same time proving cost-effective compared to alternative policy instruments, that LGS interventions can be considered successful.

In sum, there is a significant body of academic literature providing theoretical support for LGS-type interventions – and offering insights into the most effective design of such interventions. South Africa's LGS appears to have been correctly guided by such literature and was informed by the objective of correcting for such factors as information asymmetries, market failures, credit rationing and the need for sufficient multi-stakeholder policy co-ordination. On the other hand, certain key theoretical insights such as those regarding the administrative efficiency, risk sharing and design and well-conceived incentive structures were to a significant degree not taken into account, leading ultimately to sub-optimal policy outcomes such as the low take-up rate experienced by South Africa's LGS.

4. Comparative experience of LGS in other countries

Data indicates that across countries the average take-up rates of LGS-type responses to the Covid pandemic was around 48% (Hong and Lucas (2023). This is significantly higher than South Africa's LGS take-up rate of 18,4%.

For country's such as Spain and France the take-up rate was relatively high at around 75% for Spain and 50% for France (Hong and Lucas (2023). Positive design features and a high take-up rate was also reported for Switzerland's LGS (Pauletto 2023). Other countries such as the UK, Italy and Germany had lower take-up rates, with the UK take-up rate being between 20% and 30%. Although methodological differences, especially regarding whether or not governments set explicit caps for the amount of guarantees that they provided, makes direct comparisons with Italy and France difficult.

Spain launched a guarantee scheme of €100 billion, or 8% of Spanish GDP, and included an 80% government-backed guarantee. The greater recourse to LGSs was partly attributed to the lower availability of alternative fiscal relief measures in Spain (Falagiarda *et al.*, 2020). In France, the higher uptake of LGSs reflected their very favourable pricing conditions, especially during the first year of the loan (Falagiarda *et al.*, 2020).

Glanzmann, Spoerle, Wolf & Muller (2020) reported that in March 2020, the Swiss government announced a CHF20 billion bridge loan scheme, which was later raised to CHF40 billion, to assist firms in bridging their liquidity shortfalls (Glanzmann *et al.,* 2020). More than 75 000 loans were made in the first week of the program's operation. The loan terms were extremely favourable, with a 100 percent guarantee and a 0% interest rate for the first year (Glanzmann *et al.,* 2020).

A particular feature of the Swiss experience is the relatively higher prevalence of SMEs in the Swiss economy, many of which firms were highly susceptible to the fall on local demand and which had limited liquidity reserves. The Swiss scheme lent to SMEs interest free and was not administratively burdensome, with the only requirement being a declaration by businesses that they had been negatively affected by the Covid pandemic. The Swiss scheme was set up within 10 days during March 2020 and included efficiencies such as algorithms to verify clients' applications, a unique identification number for companies, and IT integration with Swiss banks and the Swiss government's e-platform (Pauletto 2023).

The comparatively limited use of LGSs in Germany was mostly due to enterprises' lesser funding needs, as well as firms' higher uses of other policy initiatives (Falagiarda *et al.*, 2020). Germany had other policy measures in place such as tax liquidity support,

an economic stabilization fund and grant subsidies, which did not have to be repaid, for companies with up to ten employees.

Despite its comparatively lower take-up rate, the Italian guarantee program had some unique feature, such as, “it covered 100% of the loan up to €25,000 and required no credit check by the bank granting the loan” which made it relatively quick for firms to obtain the needed liquidity (De Marco & Core, 2021). The study also emphasized the important role played by information technology systems in processing online applications and how efficient, well-designed systems would likely impact positively on LGS uptake.

In sum, a selection of comparative international data indicates the importance of effective policy and implementation in lifting the take-up rate of LGS-type schemes. This policy design elements include speed of set-up, ease of use and reduced collateral requirements and minimal risk taking for firms risk as key drivers of increased LGS take-up rates. An additional finding is that the presence of alternative firm support schemes will impact negatively on the LGS take-up rates in a particular country.

5. Findings on the low take-up rate of the LGS in the South African context

The impact of the Covid-19 pandemic saw the South African government respond with public health measures and economic support measures, including measures aimed specifically at assisting firms and their employees. Similarly to countries, such as, Germany and Spain, tax deferment and support measures, such as the TERS scheme in South Africa, had high take-up rates and this may have been one of the causes of the relatively lower take-up rates of LGS support measures in these countries and South Africa. Despite this, it is still important to draw lessons about how the South African LGS intervention could have been better designed in order to have improved its take-up rate and overall impact.

The South African LGS’s design flaws, such as, requirements for business directors to give security, suretyships, and guarantees, as well as limitations on the use of proceeds, served to restrict the scheme’s attractiveness. Countries which experienced

greater take-up rates, such as Switzerland, designed LGS interventions which lent to small businesses interest free and imposed limited administrative burdens, such as, only requiring business to self-declare that they had been negatively affected by the Covid pandemic.

Information asymmetry and lack of collateral make it difficult for financial institutions to engage with SMEs. Financial institutions continue using credit-serving tools for SME's that are more readily applied to larger firms, for which more information is typically available. As such, during times of crisis, coordinated action by banks, monetary and fiscal authorities is vitally important in facilitating the design of appropriate firm-support measures in order to address these market failures with the aim of creating the right incentives to overcome, or at least reduce, information asymmetries and related credit-rationing conduct.

Despite successful efforts at coordination in the South African case, the design of the LGS suffered from certain flaws – and possible accidents of timing and policy overlaps – which reduced the policy's impact as a firm-support instrument. Based on the research presented in this article, the key reasons for the low LGS take-up rate in South Africa could be summarised as follows.

Firstly, the lack of an explicit budget allocation for the purpose of supporting the LGS served as a structural limitation on the effectiveness of the scheme as the risk of financial losses still loomed large in a scheme which was backed by fiscal guarantees, but which lacked financial backing clearly specified by the public finance authorities.

Secondly, the need for the provision of collateral by borrowers resulted in a major disincentive for business owners and directors who were required to provide increased levels of security, suretyships, and guarantees during a period of crisis and elevated uncertainty, as compared to other countries that designed their LGS interventions without such collateral requirement and with significantly streamlined administrative processes.

Thirdly, the slight delay in the introduction of South Africa's LGS contributed to the low take-up rate in the sense that even though it become active in May 2020 about six weeks after the Covid lockdowns began, by that time many distressed companies had already arranged alternative forbearance measures with their banks. Counterfactually, if the LGS has been available within say 10 days of lockdown (as

was the case with the Swiss LGS), then, it is likely that the LGS take-up rate would have been higher, although even in such circumstances the other design weaknesses of the LGS that have been identified may nonetheless still have constrained the success of the scheme.

Finally, the successful TERS scheme in South Africa, which offered support to firms to be able to pay their employees through funds available in the UIF, may have offered firms an over-lapping, less onerous, and easier to access support mechanism. The fact that many firms had access to the TERS option, may also be a significant explaining factor in understanding the relatively lower take-up rate of the LGS in the South African context.

6. Conclusion

A key conclusion that can be drawn is that the specific design details of LGS-style supportive mechanisms and the related incentive structures that these design elements create are important to the degree of success – or relative failure – of such policy interventions. It should also be remembered that the Covid-19 pandemic was an unexpected and generationally unprecedented crisis in scope and scale, and in such a context, the need for immediate 'rough and ready' support interventions to assist firms and workers found precedence over pilot-projects and evidence-based planning. In dealing with future such crisis, errors would be mitigated if economic planners and policy makers would take the time to research and document the lessons to be learnt from the successes and failures of the LGS policy measures that were put in place in response to the Covid-19 pandemic.

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